Top five considerations for global real estate investing

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Most institutional investors are familiar with the appeal of holding real estate. With a low correlation to other asset classes, it can serve as an instant diversifier. Historically, real estate has delivered strong relative performance across multiple cycles, and its characteristic stable income makes it a compelling alternative to traditional fixed-income instruments.

In the past, institutional investors around the world have been domestically focused, but many are now increasingly investing in non-domestic or even global real estate. This shift has been driven by potential diversification benefits and risk reduction, as well as possible return enhancement. In smaller markets, such as Canada, a lack of domestic investment opportunities has also played a role.

Admittedly, assessing the global real estate market and the different means of gaining exposure can be a daunting task. Investors must assess various factors before making an allocation, including the impact of currency fluctuations and foreign tax laws, but they must also assess their own internal capabilities.

Generally speaking, only the largest pension plans have the capabilities and resources to construct a portfolio of directly held global real estate. Many smaller plans lack the specialist skills or resources required to manage such a portfolio.

Listed and unlisted real estate tend to have similar return characteristics over the long term but different characteristics in the short term. Listed real estate investments offer daily liquidity, with attendant greater volatility, while unlisted real estate is only periodically liquid and therefore may come with greater stability under normal market conditions.

Fortunately, unlisted global core real estate has become more accessible with the availability of open-ended funds with relatively low minimum-investment thresholds.

1. Accessibility

Unlisted funds are not new, but global unlisted funds have been used primarily for either high-risk strategies or management-intensive activities. Only recently have pan-regional open-ended core funds become available. These now total $284 billion in assets (source: MSCI IPD, as at December 31, 2015).

This proliferation provides a new opportunity for small- to mid-size institutions to consider non-domestic real estate stra tegies. It is now possible to invest relatively small amounts in global unlisted real estate and achieve significant diversification and reduce volatility.

The increasing availability of product structures around the world is opening up the opportunity for pensions plans of all sizes to access global unlisted core real estate via a single-manager solution.

2. Diversification benefits

Because real estate is fundamentally a local asset class, moving beyond one's domestic market can offer significant diversification benefits. Tenant demand for real estate is largely dictated by local economic trends, and the lack of synchronization in economic cycles around the globe has historically reduced the correlation of real estate returns from market to market.

Real estate returns from around the world have demonstrated varying degrees of correlation. Perhaps not surprisingly, the U.S. market is highly correlated to the Canadian market. Returns from the Chinese market, on the other hand, have had a very low correlation to those in Canada (see figure 1).

3. Pricing

In many markets, real estate fundamentals appear strong, and in many ways prices appear high on an absolute basis. However, unlike other asset classes – especially long-term government bonds – real estate remains priced within or below normal ranges on a relative basis.

This is reflected in the current spread between government bonds and real estate cap rates, which are effectively the income yield for real estate. In many countries, the yield spreads between real estate and local 10-year government bonds are well above their long-term averages (see figure 2). In some cases, such as Germany, Spain and Japan, the spreads are more than a full standard deviation above their long-term average.†

Singapore stands out as the only major country in which the spread was less than the long-term average in Q4 2015, while the U.S. was priced close to its long-term average.

4. Volatility mitigation

An allocation to global direct real estate can dampen volatility within a multi-asset-class portfolio, in part due to the appraisal process used to value a portfolio. Because appraisals rely on historical transactions in the market, there can be a time lag in any change in the market value of a building being reflected in its appraised value. This tends to smooth the values of unlisted private-equity real estate over time.

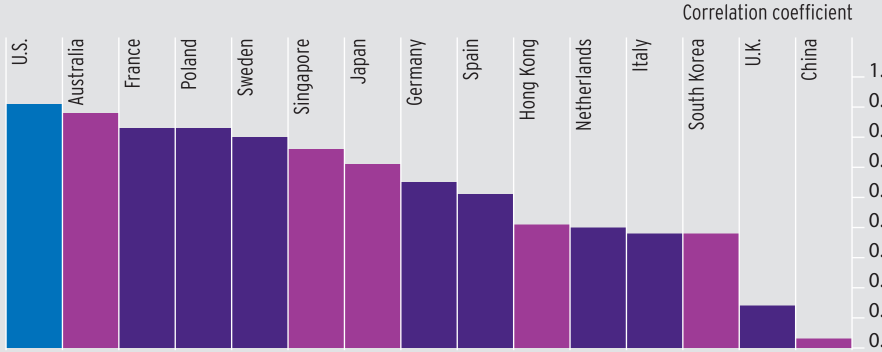
An allocation to unlisted global private real estate can help lower portfolio volatility because real estate has generally been less correlated with the more traditional asset classes (see figure 3) and has often had a low correlation with the Canadian real estate market.

A portfolio of directly held real estate is increasingly being viewed as an alternative not to equity holdings but to traditional fixed-income instruments, due to its low correlation to equities and the relatively stable, contract-based income stream it generates.

5. Expertise

Investing in real estate is fraught with legal nuance, which varies from jurisdiction to jurisdiction. Given these legal vari-

Figure 1: Correlation coefficient of unleveraged property total returns with Canada (2007–2014, all property types)



Source: Invesco Real Estate using data from MSCI IPD, as at September 2015.

ations, global real estate investors may be well-advised to seek an asset manager with a global footprint, and investment professionals making decisions in their local markets.

Due to the capital-intensive nature of real estate, scale and expertise can play pivotal roles in the ease of closing both acquisitions and dispositions.

Embedded local-market expertise can provide the asset manager with unique insight into the markets in general as well as into individual properties, allowing them to recognize and access opportunities when they arise.

Investors should also consider potential conflicts of interest when assessing a real estate asset manager. Such conflicts may include other real estate-related business lines, such as financing, leasing or property management. While some investors may feel these conflicts are manageable, others may prefer to deal with a firm that is solely focused on investment and serves as a fiduciary to its clients.

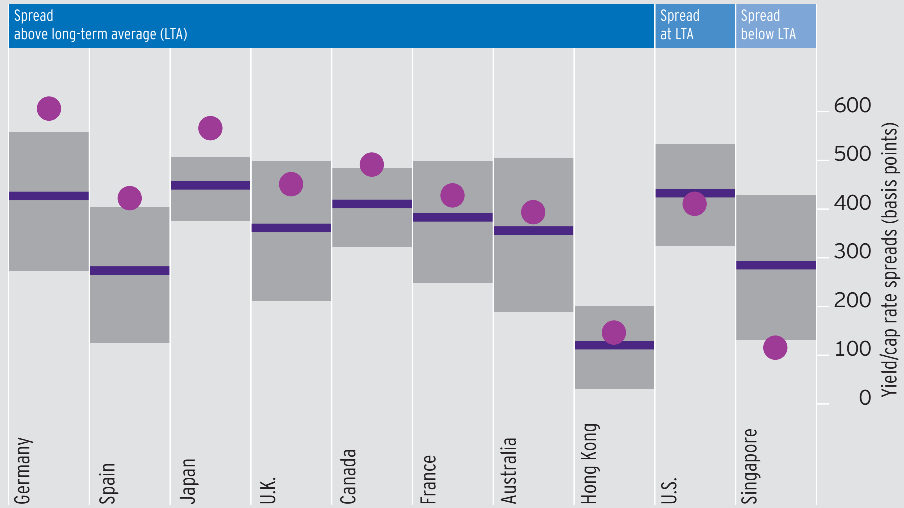
Conclusion

Going global can open up additional opportunities for institutional investors to access high-quality real estate investments in markets that are comparable in terms of size, transparency and liquidity.

Further, by investing in global real estate, institutional investors can enhance their diversification and dampen overall portfolio volatility. Given the advent of new product innovations, global real estate is more accessible than ever with one-stop-shop solutions and relatively low minimum-investment thresholds. Consequently, institutional investors contemplating an allocation to real estate may want to consider investing outside of their domestic markets.

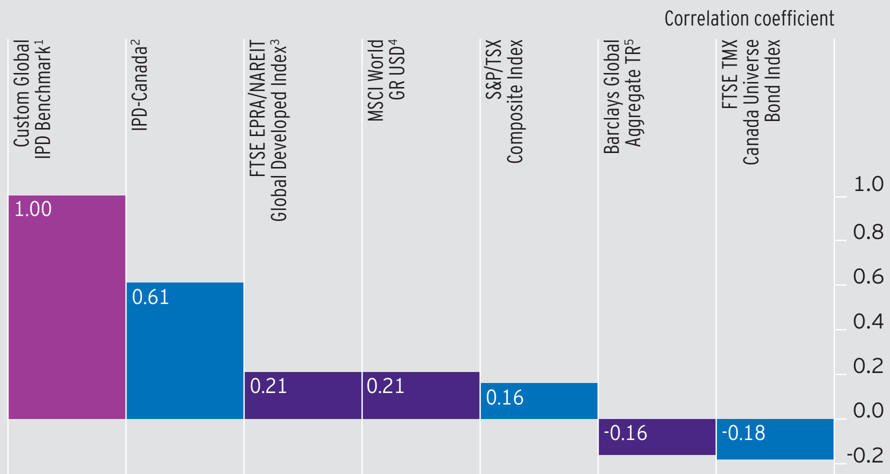
To learn more about Invesco's global real estate solutions, contact Michael Peck, Senior Vice President, Head of Institutional Investments, Invesco Canada, at 416.324.7679 or michael.peck@invesco.com

Figure 2: Yield/cap rate spreads over 10-year government bonds
● Q4 2015 — Q1 2007–Q4 2015 average ■ +/- 1 Std. deviation



Source: Invesco Real Estate using data from Real Capital Analytics, as at February 2016. Note: Yield/cap rate spreads are based on properties and portfolios $5 million and greater for office, industrial and retail sectors in each country. The data refers to properties and portfolios transacted by private equity.

Figure 3: Total return correlations of customized IPD Global Property Index with other sectors (Q1 2008–Q3 2015, local currency) ■ Canadian indices ■ Global indices



Sources: IPD (Investment Property Databank), Ibbotson Associates, Barclays, Lipper Inc., Bloomberg L.P. and FTSE EPRA/NAREIT Index, as at September 2015 and in local currencies. [1] The custom index is based on the IPD Global Property Fund Index (GPFI) reweighted to 50% North America, 25% Europe and 25% Asia-Pacific. The GPFI is a consultative index of 86 capitalization-weighted, core, open-ended, quarterly valued direct real estate funds from around the world. [2] The IPD Canada Quarterly Property Index measures unleveraged total returns of 2,350+ property investments with a capital value of C$124.8 billion, as at December 2014. [3] The index is an equity market-capitalization-weighted index composed of property company constituents that trade on several global exchanges. The returns are used here to represent the returns of global real estate investment trusts (GREITs). (N.B. GREITs are publicly liquid equity securities whose underlying assets are real estate investments. GREITs are often viewed as the liquid proxy for real estate investing.) [4] This index is a market-capitalization-weighted index designed to capture large- and mid-cap publicly traded equity representation across 23 developed markets. The index covers approximately 85% of the free float-adjusted market capitalization of the public equity markets in each country. The returns are used here to represent global-equity-market returns. [5] The index is a market-capitalization-weighted index that includes Treasury securities, government agency bonds, mortgage-backed bonds, corporate bonds, U.S.-traded investment-grade bonds and some foreign bonds traded in the U.S.

† The real estate yields/cap rates we have used are the national averages for building transactions in each country in Q4 2015 as provided by Real Capital Analytics, a data provider. This information is intended only for accredited investors as defined under National Instrument 45-106. It is not intended for and should not be distributed to, or relied upon by, the public or retail investors. Please do not redistribute this document. Where Invesco Real Estate has expressed views and opinions, these are based on current market conditions as at February 2016, and these may change without notice. Past performance is not a guide to future returns. The value of investments and any income will fluctuate (this may partly be the result of exchange-rate fluctuations) and investors may not get back the full amount invested. The value of property is generally a matter of an independent valuer's opinion. Property and land can be difficult to sell, so investors may not be able to sell such investments when they want to. Forecasts are not reliable indicators of future performance. This information does not form part of any prospectus. It contains general information only and does not take into account individual objectives, taxation position or individual financial needs. It does not constitute a recommendation of the suitability of any investment strategy for a particular investor. Nor does it constitute an offer or solicitation by anyone in any jurisdiction in which such an offer is not authorized or to any person to whom it is unlawful to make such an offer or solicitation. All data is in U.S. dollars unless otherwise indicated. All data provided by Invesco unless otherwise noted. All material presented is compiled from sources believed to be reliable and current, but accuracy cannot be guaranteed. Past performance is not indicative of future results. As with all investments, there are associated inherent risks. Please obtain and review all financial material carefully before investing. Invesco® and all associated trademarks are trademarks of Invesco Holding Company Limited, used under licence.