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LISTED REAL ESTATE - THE ASSET CLASS FOR THE MILLENNIAL INVESTOR

RESEARCH BY BNP PARIBAS INVESTMENT PARTNERS
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LISTED REAL ESTATE – *THE ASSET CLASS FOR THE MILLENNIAL INVESTOR*

Research by BNP Paribas Investment Partners

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Listed real estate has come of age as a significant asset class in its own right. Its size and diversity have expanded considerably over the last 15 years, although many investors have yet to accept this. Despite the worldwide growth in real estate investment trust (REIT) regimes and research on the potential benefits, many still favour investing in real estate directly or in non-listed investment vehicles.

Our research shows investors can improve the risk/return profile of balanced portfolios by allocating to global listed real estate. We believe one of the more thought-provoking findings is that listed real estate's liquidity characteristics – real estate stocks can be bought and sold easily – have allowed investors to continue investing in real estate despite the recent financial market volatility.

Listed real estate as a portfolio diversifier

The search for the highest possible portfolio returns has intensified in recent years as expected returns on risk-free assets have plunged. Real estate has come more sharply into focus as portfolio strategists recognise its attractive income and overall returns.

Against this backdrop, we have assessed whether listed real estate can improve the risk and return characteristics of a multi-asset portfolio, using a robust optimisation[1] technique.

Our research shows that including listed real estate in an allocation can improve returns dramatically without increasing volatility. Exhibit 1 shows the optimal listed real estate weight is almost 9%, improving the Sharpe ratio by a significant 14%.

Should REITs be included in institutional real estate portfolios?

One of the most persistent investor criticisms of listed real estate is that over the short term, these stocks behave like other equities and are just as volatile, while direct property markets and stock markets are uncorrelated, making the direct sector a portfolio diversifier, while listed real estate is not.

On the whole, academic research into the relationship between the performance of listed and direct real estate investment suggests that the returns from both asset classes are comparable in the long run. We agree. Listed real estate companies manage properties and collect rents and their capital expenditure and development costs are similar to those of unlisted real estate companies. The value of listed real estate companies is affected by the same changes in property markets and values over the long term.

Our research confirms that, in the US, direct real estate and listed real estate have a low investment return correlation over shorter time periods. However, this rises over the longer term. In the UK, this correlation has always been high and increases over time. >

by Shaun Stevens

1 Bootstrapping optimisation takes into account the estimation error in risk and return forecasts by generating several hypothetical asset return scenarios, sampling from the historical distribution of asset returns and finding the portfolio that is optimal across the simulated scenarios. We used this optimisation to find the optimal portfolio allocation which maximises the Sharpe ratio of multi-asset portfolios for global, US, EMU and UK investment universes. We considered the impact of allowing the portfolio to also invest in listed real estate. The other asset classes considered on a regular basis by investors are equities, bonds and commodities.

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Exhibit 1: Maximum Sharpe ratio portfolio allocation for a global portfolio with and without listed real estate. Monthly returns in local currencies. 30 September 1990 to 30 September 2015

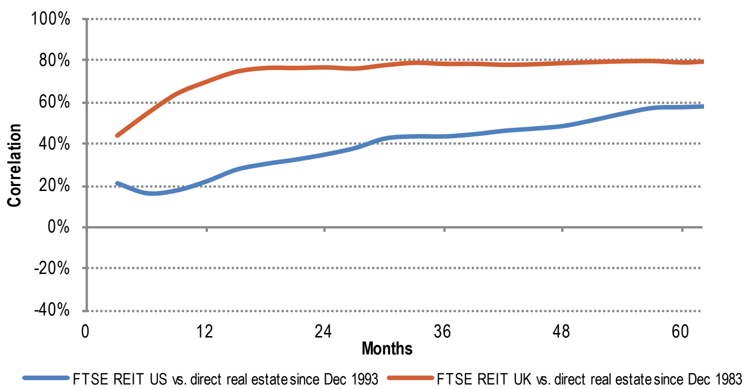
		Maximum Sharpe ratio portfolios Listed real estate	
		excluded	Included
Equities	MSCI World	19.0%	15.3%
Bonds	Citigroup US GBI 10Y+ Yea	31.8%	28.2%
Corporates bonds	Merrill Lynch Global Broad Market Corporate index	42.7%	43.5%
Commodities	S&P GSCI Commodity index	6.4%	4.4%
Listed real estate	FTSE EPRA/NAREIT Developed	0.0%	8.6%
Annualised excess return (USD)		4.9%	5.7%
Volatility of returns (USD)		5.8%	5.9%
Sharpe ratio		0.89	1.01

Data source: FTSE EPRA, MSCI, S&P and FactSet

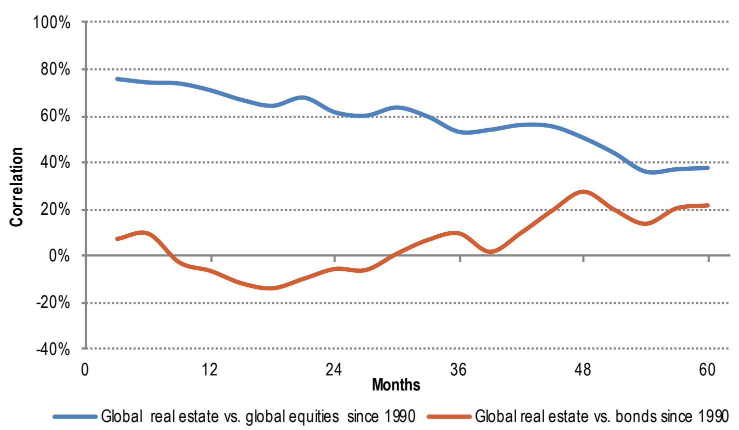
Exhibit 2 (Right): Correlations between listed real estate total returns and returns from direct real estate for the US and UK over different investment horizons.
30 September 1993 to 30 September 2015.

The results are compelling: in the shorter term, listed real estate tends to behave more like general equity, but over longer-term horizons, it is more correlated with direct real estate.

Exhibit 3 (Bottom right): Correlations between global listed real estate total returns and returns from global equities and bonds over different investment horizons.
30 September 1990 to 30 September 2015, based on quarterly returns in USD.



Data source: FTSE EPRA NAREIT, NCREIF, FactSet,, IPD based on quarterly returns in USD for the US and GBP for the UK



Data source: FTSE EPRA NAREIT, Citi, MSCI

The liquidity advantages of listed real estate

Concerns about the growing global economic and financial risks are making many long-term investors hesitant. In such a context, we believe the advantages of listed real estate market in terms of liquidity are particularly important. The flexibility of listed real estate should also be attractive to investors seeking diversified exposure to global markets.

The difference in liquidity can be illustrated >

2015						
	Listed real estate			Direct real estate		
% of portfolio liquidated	50%	90%	100%	100%	100%	100%
				fastest	average	slowest
Time required for transaction	1 day	2 days	10 days	7 weeks	5 months	> 1 year

2013						
	Listed real estate			Direct real estate		
% of portfolio liquidated	50%	90%	100%	100%	100%	100%
				fastest	average	slowest
Time required for transaction	1 day	2 days	11 days	6 weeks	5 months	9 months

Data source: Jones Lang LaSalle Inc., FactSet

by assessing how long it would take to sell a direct property portfolio and a similarly sized global listed real estate portfolio.

Let's define the global direct real estate portfolio. This consisted of EUR 1 billion of prime modern properties: 35% office, 35% modern shopping centres, 10% residential, 10% industrial & hotels and 10% others. All were class A properties located in major global or mega cities, with 45% in North America, 40% in Asia Pacific and 15% in Europe.

Our EUR 1 billion listed real estate portfolio consisted of the FTSE EPRA NAREIT global developed index stocks. Current market conditions are determined by the recent traded volume for each stock[2].

Separated into three regional sub-portfolios, the direct real estate portfolio would take an estimated 6-8 weeks to sell in optimal market circumstances, around four months in current market conditions (November 2015) and more than a year in less favourable market conditions. It would take just two days to sell 90% of the listed real estate portfolio and 11 days to dispose of it fully.

The research also shows that it takes slightly more time to sell a large global portfolio of good quality direct assets than two years ago, when this analysis was first carried out, even though demand in underlying occupier markets is now better than 18 to 24 months ago. This suggests investors are becoming more discerning as they conclude that the market is entering the latter stages of the cycle.

Exhibit 4 (Above): Average number of days to liquidate 50%, 90% and 100% of a EUR 1 billion global portfolio of listed and direct real estate in similar market conditions as those in 30 November 2015. Local currency terms, monthly data 2015.

Conclusion

This BNP Paribas Investment Partners research reinforces the findings of academic research by many others, including the European Public Real Estate Association. The research shows that listed real estate can adequately replace direct real estate in investor portfolios as it offers a comparable exposure to direct real estate over the long term. It makes sense for portfolio managers to add listed real estate to a multi-asset portfolio to generate alpha. Listed real estate has significant liquidity advantages, allowing investors to change allocations in a matter of days.

Given the current uncertainty in global capital markets and economies, we believe investors can earn higher returns by considering an allocation to listed real estate.

Shaun Stevens
Shaun Stevens is the real estate strategist in the listed real estate team of BNP Paribas Investment Partners and is responsible for investment strategy. He has worked for the company in real estate investment since 2007 and has been active in the real estate industry in a number of analytical and investment advisory roles for more than 25 years.
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2 The selling rule allows for selling up to 25% of the recent average volume of each stock every day. We used the average volume estimated over the previous 20 working days and the average monthly volume estimated over the last five months. These two averages are comparable and the results are the same whichever we use.