

Schroders TalkingPoint



Listed or unlisted: What's the best way to invest in real estate?

We explore whether combined real estate portfolios, blending listed and unlisted strategies, can improve the returns that investors can achieve from their real estate allocation.

Blending direct and indirect real estate exposure could improve returns

The position of real estate in an investor's portfolio has long been debated. Whether the asset class should be included at all is rarely questioned, but the issue of which structure to use to build the allocation is less clear-cut. Indeed, having scrutinised a number of academic papers written on this issue, it appears that few investors have the optimal allocation to real estate.



Tom Walker

Co-Head of Global Real Estate Securities

Over the last five, ten or fifteen years, an allocation to listed real estate has been demonstrated to provide increased returns relative to an unlisted real estate allocation. However, investors must weigh the increased returns against increased volatility when compared to an unlisted investment. In our view, the optimal allocation to real estate comprises a 'blended' portfolio.

Higher real estate demand is leading to greater scrutiny of real estate allocation

Structural changes to the pension fund industry – with the move from defined benefit (DB) to defined contribution (DC) – as well as other long term factors such as demographics, are leading many investors to question whether they have the optimal asset allocation to serve their needs in the future. We believe that these factors will also lead to increasing allocations to the real estate sector, as investors appreciate both its income and capital growth potential. The question now, is how best to achieve this real estate exposure.

While unlisted real estate funds have been the favoured option in the past, there is growing evidence that a purely unlisted real estate allocation is no longer the most efficient use of capital. For many investors, existing unlisted allocations can often be characterised by:

- A lack of sufficient diversification, with too many assets in one region, country or sub sector.
- Illiquidity in the portfolio, as a result of investing only in unlisted real estate funds or owning assets directly.

As investors analyse their existing real estate allocation and think about the future, we believe that liquidity will be a key consideration. What is the benefit of reduced volatility if you cannot redeem funds when required?

A number of investors now combine a less volatile unlisted real estate fund (or direct ownership) with more volatile listed real estate exposure. Both practical and academic evidence demonstrates that this gives investors the optimal blend of risk and return benefits.



It is important to point out that the difference in volatility between unlisted real estate funds and the listed real estate sector is less significant, over the long term, than one might expect. Research shows that both types of exposure to real estate will provide investors with similar returns over a more extended timeframe.

Over the short-term there may be a difference in pricing between the two markets. This is due to the listed market pricing assets looking forward, using evidence as the market announces new information, such as leasing or investment transactions. In comparison, unlisted real estate funds will value assets (normally) every six months or perhaps annually and valuers will largely rely on historical evidence. The critical and common theme is that both markets are pricing the same assets. Therefore, the same direction will be followed, whether prices are increasing or decreasing and investors over the long-term should experience the same returns.

Investment case study

In order to appreciate the benefits of a 'modern' (blended) real estate allocation – one that combines owning an unlisted fund with holding listed real estate – the UK government's DC pension scheme provides an interesting case study.

The National Employment Savings Trust (NEST) is the UK's DC pension fund, and has an allocation of 20% to real estate. Such a large allocation has not been seen since the 1970s and is considerably higher than average UK pension funds¹. The NEST allocation consists of a 70% weighting to the UK direct real estate market via an unlisted fund and a 30% weighting to the global listed real estate sector.

Why the listed sector is included in the NEST real estate allocation

There are a number of reasons that NEST uses listed instruments in its real estate allocation, including investor requirements, regulation and basic practicalities.

Following the last financial crisis both investors and consultants placed an increased emphasis and importance upon liquidity. As stated earlier, the benefits of an investment are lost if an investor cannot redeem their funds when required, making it a critical component of any investment.

The regulatory environment is driving DC schemes towards blending. DC funds are obliged to provide investors with both liquidity and daily pricing. This is not possible with a purely unlisted allocation, despite the availability of directly invested funds which deal on a daily basis. In the cases of a 'run' on a fund, during which time a large number of investors attempt to sell their units at the same time, assets simply cannot be sold quickly enough, and dealing would have to be suspended.

Finally, as investors such as NEST increase allocations to real estate there are many difficulties diversifying this allocation and investing in multiple markets across the world. The cost, legal complexities and infrastructure needed to operate a global real estate platform often means a listed investment is the best way to gain exposure to a particular market. It is also clear that many listed real estate companies own portfolios that cannot be replicated solely by an unlisted real estate fund – Westfield London, Carnaby Street (London), Empire State Building (New York) and Causeway Bay (Hong Kong) are great examples of unique assets which are owned by listed real estate portfolios. In addition, many listed real estate companies provide strong corporate governance and a high level of transparency, wrapped up in investor-aligned corporate structures.

Reducing volatility without sacrificing return

There is clear evidence that listed real estate will provide investors not only with greater liquidity and strong corporate governance, but can also offer a significant performance premium.

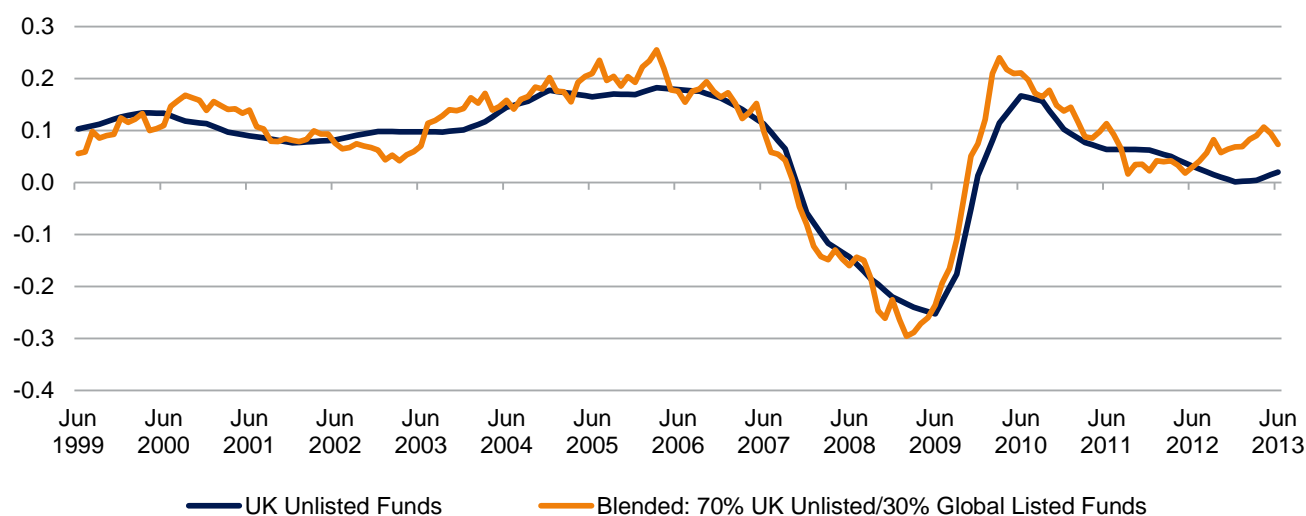
Assuming the NEST allocation of 70% to unlisted and 30% to listed, over the last 15 years investors could have benefited from a total return enhancement of 19% (c. 1% p.a. annualised) when compared to an allocation solely to unlisted real estate. Over the last 10 years, the enhancement would have been 43% (c.2% p.a. annualised), and over the last five years 390% in absolute terms (or 4% p.a. annualised).²

Importantly, even analysing returns during one of the most volatile financial periods in recent history – the financial 2008-2009 crisis – the blended portfolio still rewards investors. A small performance reduction during the crisis is compensated for by increased returns shortly afterwards. The chart below highlights these points.

¹ONS, Business Monitor MQ5.

²EPRA Research 2014 – 'The performance implications of adding global listed real estate to an unlisted real estate portfolio: A case study for UK Defined Contribution funds'.

UK unlisted real estate exposure versus a blended approach:



Source: Consilia Capital, as at 30 June 2013.

The returns of a blended portfolio are as you would expect, given the predictive nature of the listed real estate sector. Namely, when direct real estate values are rising steadily (as in 2009 – 2014) the listed element enhances unlisted returns. By contrast, when values are falling (as in 2008 – 2009) they detract from performance but only marginally. The long term benefits outweigh the costs.

Another interesting case study is the Norwegian Sovereign Wealth Fund (Norges). The objective for this fund is very different to NEST. To quote from the Norges website:

“The fund invests for future generations. It has no short term liabilities and is not subject to rules that could require costly adjustments at inopportune times.”

“Our goal is to build a global, but concentrated, real estate portfolio...The strategy is to invest in a limited number of major cities in key markets”³

With such a long term focus the need for liquidity is reduced, yet the Norges fund is still a large investor in many listed real estate companies.

We believe that the reason Norges is invested in leading listed real estate companies is the same reason that applies to every investor, whether a large institution or an individual. The quality of certain portfolios and management teams are irreplaceable and unique. Combining this with the diversification benefits achieved by investing in a number of sub sectors, cities and countries, results in a compelling investment case.

Balance is key

The exact composition of any investor’s portfolio will depend on their particular needs. Similarly, the blending of listed to unlisted in a real estate portfolio will depend on their particular requirements. Supported by various academic works and market evidence, we hope to highlight to investors that the benefits of the blended approach are clear. We believe that investors could experience improved returns when compared to a more traditional approach to real estate.

Additional sources:

1. EPRA Research 2014 – ‘The performance implications of adding global listed real estate to an unlisted real estate portfolio: A case study for UK Defined Contribution funds’.
2. Hoesli, M and Oikarinen, E 2013 – ‘Are REITs real estate? Evidence from international sector level data, Swiss Finance Institute Research Paper Series Number 12 – 15.
3. Pensions Institute and Cass Business School 2013 – ‘Returning to the core: Rediscovering a role for real estate in Defined Contribution Pension Schemes’.

³Norges Bank Investment Management (Norwegian Sovereign Wealth Fund) : www.nbim.no/en/.

Important Information

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