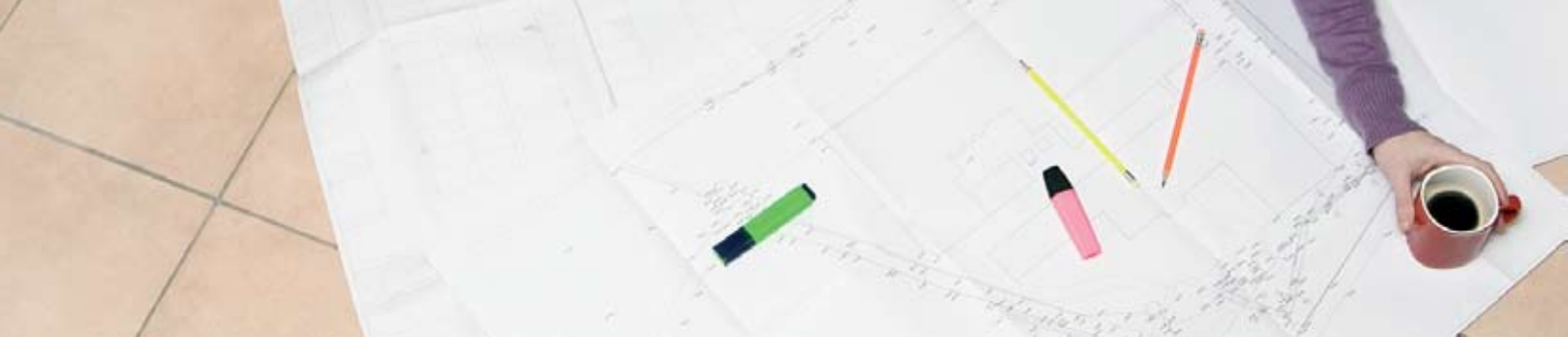




Global real estate



With mixed local market property conditions, many investors are looking more widely at global real estate opportunities. We asked one of Watson Wyatt's real estate specialists what potential exists in this asset class.

Why are pension fund trustees now taking another look at actively managed real estate as a potential source of value?

The asset class has evolved considerably in a relatively short period of time, offering potential in overseas and indirect investment. The market is no longer opaque and is rather characterised by specialists and competent investment managers who have set high standards of open communication and disclosure. Combining this with the needs of a changing pension fund environment, we believe it is time for pension funds to take a closer look at real estate, particularly from a global perspective. Although investors have been thinking globally about their other asset classes, they are only now putting this into practice for real estate.

What has made them change their minds?

Previously, a real estate portfolio was mired with problems. Investment managers' strategies were limited to buy and hold, focused on local geography, and allocations were capped and highly constrained in an opaque market. In addition, investors were discouraged by poor returns and an inflexible regulatory environment and confused by real estate's similarities to both equities and bonds.

Is there a strong case for global real estate?

In a word, yes. Recently there has been a structural change in how investors look at the asset class – they are now thinking and acting globally. Pension funds, generally, have experienced very strong returns from their local real estate allocations. This has been a function of yield compression and rental growth, mostly caused by factors outside of the sector, such as lower interest rates and inflation with strong economic growth. The effect has been marked, with buy and hold real estate strategies proving to be excellent performers. Increasingly, funds are also recognising that they have a geographical concentration in their home markets, hold assets with a single manager and employ a successful but yet simplistic investment strategy of buying and holding. At the same time, attention is now globally focused and on the future of the real estate cycle. As such, investors are now rightly becoming much more demanding and are seeking out alternative real estate investment strategies that can offer sustainable returns while reducing risk through added diversity. In our view, a global real estate mandate, managed by a skilled investment manager, can be a helpful addition to a portfolio.



How are the best global real estate managers distinguishable from the rest?

Skill. Real estate investment managers that are thinking and acting within a global opportunity set are identifying investment opportunities and ideas that set them apart. They can employ a mix of professional skills (planners, architects, financiers, operators and so on) to invest in those ideas and skilfully implement them.

A fundamental component of our research into global real estate managers is that they can be distinguished by type and style. Manager type is a characteristic that highlights that different business models tend to bring different competitive advantage skills. We believe that it is also important to look at manager style, which is the ability to implement the investment opportunity and consider how this might differ from another investment manager. Ultimately the objective is to understand the amount of risk and costs to capitalise on an elaborate investment opportunity versus a simplistic approach.

This is particularly the case for longer-term investors, like pension funds, that typically invest through the cycle and thereby benefit from an illiquidity premium.

Are there any skilled investment managers in this space?

Yes. The opportunity set for the investor has increased substantially and skilful and talented managers from non-traditional real estate backgrounds are the new entrants.

What is clear is that these investment managers are the new kids on the block and are designing innovative products in small teams, often with a clear vision of the future, dealing directly with the cyclicity of the asset class. As a consequence, there is likely to be a greater range of investment products that better suit the needs of pension fund clients. These are the investment managers that are looking at delivering real estate returns through other means – such as using debt, complex instruments or arbitrage opportunities within the real estate market and across the globe. Equally we are expecting to see much greater use of derivatives and other real estate-like options, such as open-ended funds and Real Estate Investment Trusts as instruments for managing risk.

Can any fund make a success of global real estate?

When constructing a real estate strategy, funds ought to be aware of their governance budgets so as to settle on the most appropriate approach. For those with a smaller governance budget there are now more passive alternatives to choose from, although benchmarking in this area is fraught with difficulty (notably embracing the cyclicity of a benchmark), and the subjective nature of appraisal valuations partially obscures the true volatility of property. But for those who have a higher governance budget, a global real estate mandate in the hands of skilled investment managers could be an attractive strategy.