Real estate: why diversification is more than a buzzword

The pandemic has shown the value of a broad asset range and flexible allocation

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In the blink of an eye, the pandemic has turned real estate certainties on their head. Value has virtually disappeared from some real estate sectors and has soared in others almost overnight.

The pandemic has upended another certainty: that interest rates and inflation would stay low. In the aftermath of the pandemic, inflation risks have risen and inflation-adjusted returns are a priority for many investors.

Given the emerging risks, we see real estate investors more than ever seeking to diversify their assets and future-proof their income streams.

Sectoral demand tilts towards alternative real estate

Despite gloomy predictions, we think the office market will prove resilient over time. In retail, meanwhile, there has been a negative repricing of values to the extent that some investors believe there is no future for the sector.

But the long-term prospects for some retail assets are sound. In the pre-crisis era, investors were increasingly taking an interest in sectors classed as "alternative". Alternative real estate includes residential housing, life sciences, data centres, healthcare and student housing.

The interest in alternatives persists post-pandemic given that alternative real estate offers the potential to boost inflation-adjusted cashflow. In fact, the shift in direction has been so strong that competition for some alternative assets has become fierce. However, we have been investing in alternative assets for many years and we see selected assets as representing good value and providing years of rental growth.

Responding to investors' differing ESG ambitions

ESG is pivotal for future-proofing real estate portfolios. Green buildings attract more and higher-quality tenants. In addition, a low-energy building is cheaper to run: the costs of reducing energy consumption can be less than 10% of the energy costs saved.

AEW applies innovative sustainability technologies across our real estate portfolios. These include geothermal technologies, cold storage systems, ground-coupled heat exchangers, data management, energy performance contracts, and software applications that measure ESG performance in buildings. We are also introducing climate change stress-testing as a forward-looking measure of sustainable impact.

Real estate investors have varying views on sustainability and what it means to them and we think we can respond to all levels of ambition for ESG investing.

Diversity is another key aspect in defining future value in real estate. We spend a lot of management time on the E and S of ESG. It's critical for clients and for attracting talent

Staying at home no longer an option

One well-established mechanism for future-proofing real estate is geographic diversification.

All the available evidence is that geographic diversification adds considerable value. Whereas world stock markets tend to rise and fall in tandem, there is low correlation between real estate assets in different geographies. There is almost no correlation, for example, between the value of office space in the City of London and in central Paris.

US investors have good reason for doubting geographic diversification: they often wonder why, given the size and variety of their home market, they should allocate outside the US. US markets offer potentially higher returns over the long term, but there is higher volatility too. That becomes relevant when an investor such as a pension fund or insurer needs liquidity at a time of high volatility.

Asia is a key component of future-proofed RE portfolios

We are finding that investors are far more open to real estate allocations in Asia. Exposure to Asia is today seen less as a portfolio risk and more as a diversifier and source of attractive returns.

Asian economies are more resilient than in the past and the five-year growth outlook is strong at 3.5% a year on average[1]. Asian real estate markets have deep pools of liquidity, and have been benefiting from a sizeable weight of capital dedicated to the asset class.

We have over 40 employees in Asia across five offices, and our seasoned APAC senior management has completed $5.6 billion of transactions in Asia since 2014. Recent deals include a mixed-use building in a key central location of Beijing, an office building located in the heart of Melbourne CBD and a high-tech industrial office building in Singapore.

Program investing and co-mingled funds

Some real estate investors have very precise investment needs or have a strong conviction about a particular market segment. They may, for instance, require program investing, implemented through separate accounts and sometimes in tandem with operating partners.

Program investing is a direct approach to real estate and may be focused on a particular sector, such as senior or student housing, residential assets or logistics development.

While program investors often require separate mandates, other investors prefer co-mingled funds where they can access a wide range of assets at smaller ticket prices. Other investors besides like to express their convictions through co-investments.

A large global platform such as ours allows for all these structures, and can also enable club deals, where a number of clients on our platform combine to do a deal they otherwise would not be able to participate in.

The flexibility of a single, global platform

To access the kind of flexibility that future-proofs a real estate portfolio, investors are increasingly seeking a single platform, preferring to limit the number of real estate managers they work with. Investing alongside a single manager gives investors opportunistic access to deals, and all the reporting and servicing they need to manage their investments and communicate with clients and regulators.

It also increases flexibility, allowing them to invest in anything from US office space to German retail to match their changing risk-return expectations and their ESG perspectives. Real estate investors are finding that the list of real estate firms that can do all this – and execute on a global scale – is pretty short.

FOOTNOTE

1 IMF – Regional economic outlook 2021

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