Why cities? Why global?

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REAL ESTATE

Nuveen Real Estate explains why an investment approach for global cities needs to create a diversified portfolio of resilient assets positioned for the long term.

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The viability of a cities-based real estate strategy appears questionable in these challenging times. Our day-to-day activities in cities around the world have been altered in ways few of us would have imagined just a few months ago.

The spread of the coronavirus, the disruption to our daily lives, and the toll on health and human life are alarming. But we are adapting. Hygiene and health care are a greater priority than ever. Many of us are working, shopping and even socialising online.

City life, however, seems diminished amid restrictions on movement and travel. But we expect that over the medium to long term, the greater economic opportunities and the dynamism of the world's cities will continue to make them attractive places to live and work. Already more than half of the world's population live in urban areas, according to the United Nations, and this is predicted to continue to rise.

Urbanisation, however, will be far from uniform. That is why selecting cities for a diversified, cities-based real estate strategy needs a rigorous and comprehensive approach.

Why cities, not countries?

Rural-to-urban migration in North America and Europe has slowed, but it continues at pace in Asia Pacific. Led by China and India, Asia Pacific is expected to account for nearly half of the world's output by 2030, with more than 50% of the world's urban population growth and almost all of the top 50 global cities by size (in GDP terms).[1]

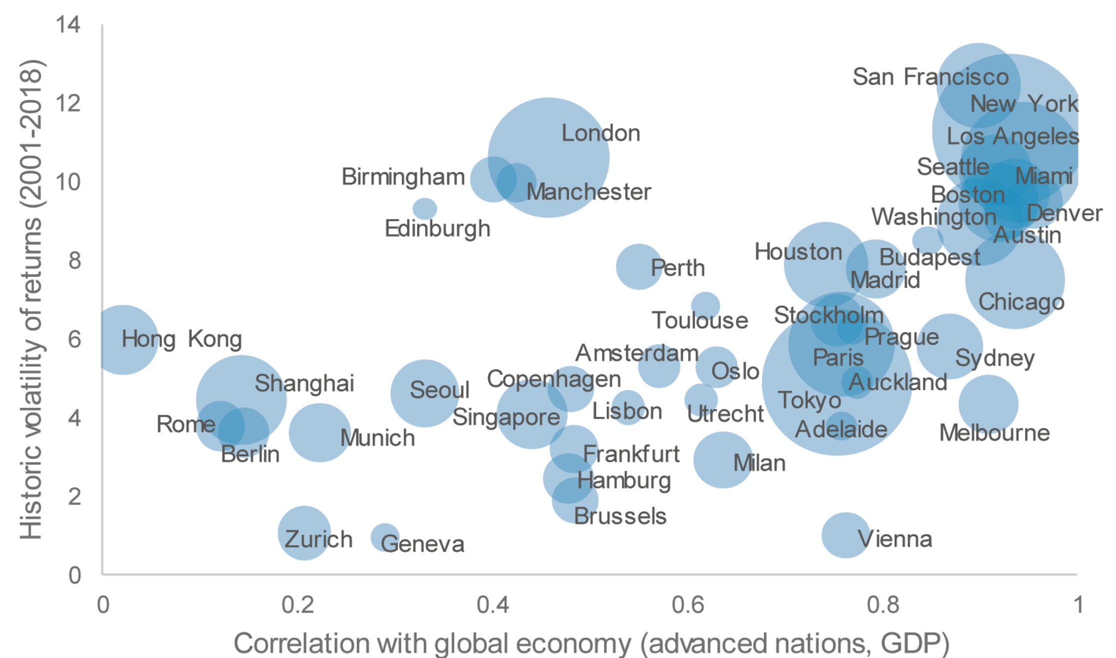
Cities, unlike countries or regions, will likely see their share of global real estate investment grow to reflect more closely their new economic status and share of the global economy. This will open the door to new and more sophisticated real estate strategies, giving such cities a pivotal role in a portfolio.

When looking for resilient real estate opportunities – assets that will remain relevant through market cycles – we favour investments that benefit from being a part of the fabric of a winning city, and even contribute to that city's success.

We estimate that fewer than 100 cities globally have sufficient scale and stability, and are well positioned to benefit from long-term structural drivers of demand for real estate. These drivers – demographic megatrends, technological innovation and sustainability matters – are rapidly changing the nature of demand for real estate, and so ought to be the foundation of any long-term investment strategy.

The successful cities of tomorrow's world will grow their share of their respective regions' output through their ability to attract talent and tenants, and in turn enjoy improved productivity. Conversely, the cities that will see their position in the global economic hierarchy compromised over coming decades should be avoided by investors pursuing resilient strategies.

Figure 1: Cities and the global economy



Source: Nuveen Real Estate, Q1 2019

Why global?

All cities have unique characteristics, which means investing across a range of cities within a single economy will provide some diversification benefits. But historic real estate performance data shows that, in most cases, cities within countries are highly correlated.

Diversifying regionally should improve this but it also has its challenges. It is easier to do in some regions compared with others. Major U.S. cities, whose fortunes are to some extent tied to one national economy, are highly correlated with each other. Figure 1 illustrates the return volatility for cities and how they correlate with global economic activity. With Europe or Asia Pacific comprised of so many different economies, achieving diversification is naturally much easier than in the U.S.

When performance is broken down by sector type, a different picture also emerges. Looking at prime office market data, we find that global gateway cities are more closely correlated with each other. London's prime office market has a stronger correlation with New York (0.74) and Paris (0.76) than with the U.K.'s Birmingham (0.31), even though London and Birmingham are very neatly correlated when looking at average all-property type performance (0.89).

Sector diversification has a role to play as well. It is well known that the office sector is more volatile than retail, but volatility varies more by city than it does by sector. Volatile office markets tend to have volatile retail markets. Dublin, for example, is the most volatile city in Europe for both sectors according to our research. A few exceptions are tech-driven office markets, namely San Jose or San Francisco, which have seen very volatile office market performance through the last cycle yet relatively stable retail performance.

Personality and performance: opposites attract

Global gateway cities should form a component of a resilient, city-based strategy, but many of these cities are strongly correlated. Performance volatility could be lowered by investing across different sectors and sub-markets, bringing different city personalities into the mix.

Regionally and domestically driven cities tend to be better diversifiers and should be included alongside global gateways in a portfolio. Strategies to do this include balancing investments in cities driven by financial and business services with energy or education-based markets or adding structurally driven markets to highly cyclical cities.

Conclusion

Ultimately, a portfolio comprising a team of cities whose fortune and future success depends on a range of different drivers – be it inward migration, productivity, quality of life, infrastructure or innovation – should enjoy the benefits of diversification.

Diversification is further enhanced by taking a global approach. After all, real estate markets around the world are at different levels of maturity, different stages of the cycle and have different growth rates.

A diversified and global approach should increase the resiliency of a real estate portfolio. In challenging and difficult times, it's natural and often appropriate to focus on the short term, however if investors can maintain their long-term vision, especially for their real estate investments, they will increase their chances of investment success.

Source:
1 Oxford Economics