HOT PROPERTIES

What real estate is doing in your portfolio

Catherine Marshall, CFA

Like the grizzled veteran who goes from obscurity to celebrity on Oscar night, real estate is suddenly the toast of the town, yet its success has been decades in the making. That's what participants at CFA Society Toronto's luncheon "What Real Estate is Doing in Your Portfolio" heard during a presentation by Investment Property Databank (IPD) at the National Club earlier this year. IPD Managing Director Simon Fairchild told the sold-out audience that he stumbled into the commercial real estate index business in the 1990s, a time when property investment had fallen out of favour with institutions. Unfortunately, it remained so for many years, despite strong income production and recovering asset values. However, property investments are now in vogue among new classes of investors such as sovereign wealth funds as well as more traditional institutional investors. "It's amazing how far this asset class has come during my career," he said.

To demonstrate the changes in real estate's popularity, Mr. Fairchild showed the audience investor intention surveys for 2013 in which 53 percent of respondents planned to make new commitments to direct property investments, compared to 36 percent last year. Mr. Fairchild said that investors cited a number of reasons for their current enthusiasm for real estate:

- 90% cited diversification
- 64% cited volatility management
- 45% cited alpha generation
- 45% cited long-term growth
- 30% cited inflation hedging

Surprisingly, said Mr. Fairchild, one of the traditional reasons for real estate investment—namely, income generation—was not even mentioned in the study. Also, after an extended period of extreme monetary stimulus, investors should attach a high value to real estate's inflation protection qualities, he noted.

THE CANADIAN MARKET

Zeroing in on the Canadian market, Mr. Fairchild said it is only now getting the attention it deserves after a long period of very strong returns. Using the REALpac/IPD Canada Property Index to demonstrate the performance of the Canadian institutional-grade market, Mr. Fairchild showed it has outperformed larger and higher profile markets such as the U.S., U.K., and Germany, as well as the IPD Global Index over one-, three-, five-, and 10-year periods. In 2012, Canada was the top-performing real estate market in the IPD Global Index, and Calgary was the top-performing city market.

"Calgary and Barcelona were worlds apart, at least in 2012," Mr. Fairchild commented, as he explained that North American markets were strong, while European real estate markets had weak-to-declining performance last year, with Barcelona as the worst performer.

City comparisons were just one approach Mr. Fairchild used to illustrate the power of global diversification within a real estate mandate. Geographic diversification is a more powerful risk mitigator in real estate than securities, he said, because real estate return performance is more sensitive to local GDP and job growth than to global capital flows or other macro factors.

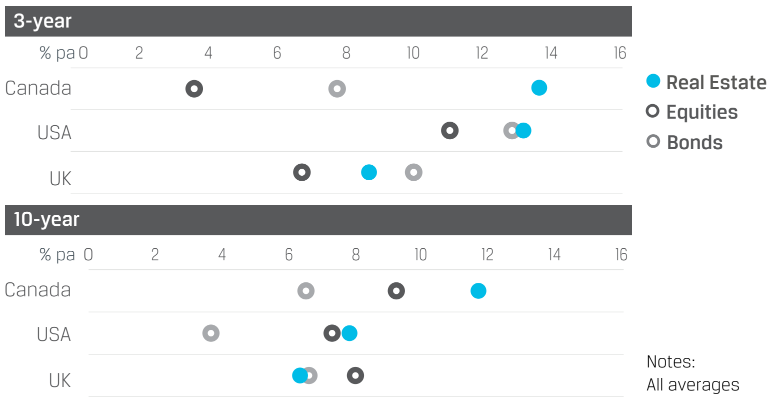
Since its inception 12 years ago, the IPD Global Index has produced fairly steady returns dominated by income production. The annualized return since inception is 7.8 percent, while the return over the last three years has been 8.8 percent. Interestingly, said Mr. Fairchild, neither the IPD Global Index nor many country indices have behaved as theory suggests, i.e., producing long-term real estate return performance below that of stocks but above that of bonds. In fact, over three- and 10-year annualized periods, real estate outperformed both stocks and bonds in many countries, including Canada.

Canada stands out in a cross-country comparison because real estate outperformed stocks and bonds in annualized one-, three-, five-, and 10-year periods. Mr. Fairchild demonstrated that, when volatility and return are both examined together, the Canadian direct property market produced higher returns at a volatility level similar to long-term bonds. When the Canadian returns were broken down by city, Calgary had both significantly higher returns and volatility compared to the national index.

THE TRANSPARENCY CHALLENGE

Mr. Fairchild used a comparison of various city-level risks and returns within Canada to underline some of real estate's investment management challenges. He said that the geographic composition of the portfolio and the property sectors chosen were the primary sources of variability within a real estate portfolio, while the wide range of levels of market transparency around the world was the greatest driver of market risk internationally. Canada ranked high in international transparency rankings, which contributed to its low volatility.

NATIONAL PERFORMANCE ACROSS ASSET CLASSES



Sources: Direct property: IPD Equities: MSCI Bonds: JP Morgan 7-10 years

Notes:
All averages as of 2012 YE
TR = total return

When Mr. Fairchild first entered the real estate industry, it was in its infancy as an institutional asset class, and it was dominated by real estate operators such as property managers and brokers who had little understanding of investment management. Looking out at an audience of CFAs and other investment professionals who are either actively working in, or interested in, real estate portfolio management issues, he commented "how far this asset class has come."

Catherine Marshall, CFA is the Vice-Chair of CFA Society Toronto Risk Management and Alternative Investments Committee and an active consultant in investment real estate.

