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Listed real estate allocations gather pace

THE EUROPEAN PUBLIC REAL ESTATE ASSOCIATION'S (EPRA) CEO PHILIP CHARLS ANALYSES PENSION FUND INVESTMENT IN REAL ESTATE

Real estate is the most significant alternative asset class for pension funds, averaging around 10% of institutional portfolios. The split between listed and unlisted real estate varies widely, but some of the largest institutional investors, such as the big Dutch pension funds, have close to a 50/50 distribution.

Against a backdrop of historically low interest rates, European listed real estate companies have been popular with investors globally. The industry has punched far above its weight in capital raising in comparison with most other stock sectors. Companies in the FTSE EPRA/NAREIT Developed Europe Index have yielded a dividend on average of 3.9% over the past five years. The index has consistently demonstrated a strong long-term performance – the annualised 20-year total return for the Developed Europe Index stands at 9.6%.

Despite this strong performance, pension funds are still missing out on higher returns by excluding real estate stocks from their investment portfolios.

Blending listed and unlisted real estate

The improvement in performance through adding real estate investment trusts (REITs) to a multi-asset institutional portfolio, or increasing the listed element of the property allocation, has been confirmed by extensive research.

A 2014 research paper by Moss and Farrelly showed the benefits of the blended approach as it applied to UK defined contribution pension schemes. A pension fund portfolio that combines a 30% global listed allocation, with UK non-listed funds, delivered an annualised total return of 7.5%, outperforming portfolios with no real estate stocks by ca. 1%.

Research in the German market also found that by blending a 30% global listed portfolio with a 70% allocation to Spezialfonds (the preferred real estate vehicle for German pension funds), the real estate allocation returns increased from 2.9% to 5.4%. The weight of evidence is clear – investors who ignore the listed real estate market seriously risk underperforming those who embrace it.

The way forward

Following the announcement by the European Central Bank (ECB) in January 2015 that it would start its quantitative easing programme, interest rates across Europe have been declining and hitting returns from fixed income investments. Since 2015, we have seen increased demand for European listed real estate from institutional investors, such as sovereign wealth funds, which are looking for a long-term investment with significantly higher yields than government bonds. In the first week of April, Norway's giant oil fund announced it was raising the cap on the real estate allocation in its portfolio to 7% from 5%. At the end of 2015, the fund held 3% of its assets in real estate. The new cap would allow an additional €14 billion to be invested in real estate this year, clearly demonstrating the huge potential for growth in the sector.

Geographical and property sector diversification enables pension funds to benefit from the expertise of listed real estate companies across Europe, giving them a competitive total return, alongside a highly liquid investment, when compared with direct real estate.

Reforms at a national level are crucial to encourage institutional capital to invest in listed real estate. A good way to start would be the wider adoption of REIT or REIT-like structures, as currently, only 14 member states have a REIT regime in place, hindering cross-border investment. At the same time, companies and analysts should maintain their efforts to explain the key benefits of REITs, such as liquidity and a long-term performance, aligned with physical property, which outweigh any short term volatility.

Written by Philip Charls, CEO, EPRA ■

AGAINST A BACKDROP OF HISTORICALLY LOW INTEREST RATES, EUROPEAN LISTED REAL ESTATE COMPANIES HAVE BEEN POPULAR WITH INVESTORS GLOBALLY