



## Managing Risk In Commercial Real Estate Investment

**Max Arkey**  
Vice President  
Product Management  
MSCI Real Estate

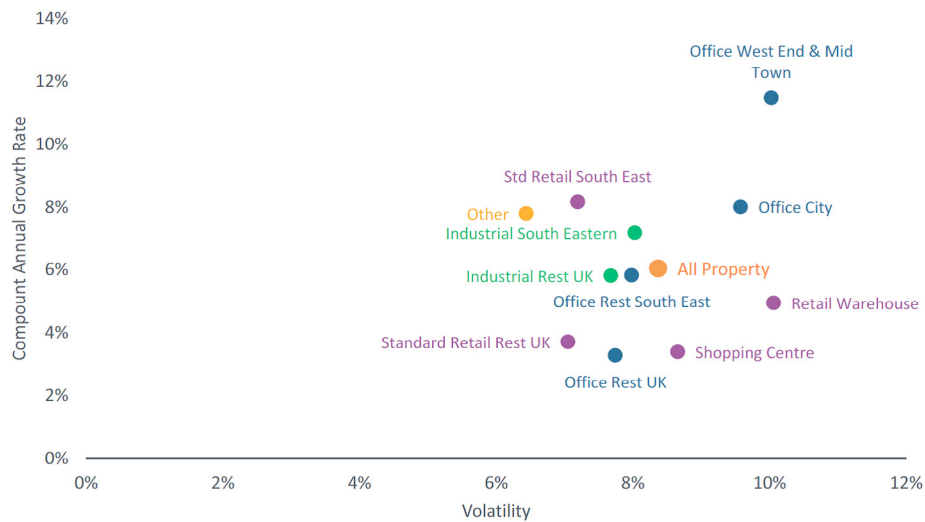
### Portfolio Risk

Real estate can perform such diverse roles within a multi-asset class portfolio thanks to the breadth of investment options available within the asset class. Depending on the type of asset or its location, the risk and return drivers can vary substantially. For instance:

- Healthcare assets often benefit from high levels of government support via patient subsidies and thus are usually less prone to economic cycles.
- Retail assets can have turnover rent built into their lease agreements meaning that the asset owners can benefit from an increase in retail sales.
- Hotel assets do not have the same income certainty as other assets and can be vulnerable to changes in occupancy or room rates.

- Assets in major cities are more likely to be of higher quality grades than those in other regions and therefore attract different tenants. Changing the allocation within a real estate portfolio between different sectors and segments can therefore have a material impact on the behavior of the portfolio. Exhibit 2 below compares the risk and return performance across UK market segments over the 10 years from April 2005 to March 2015.

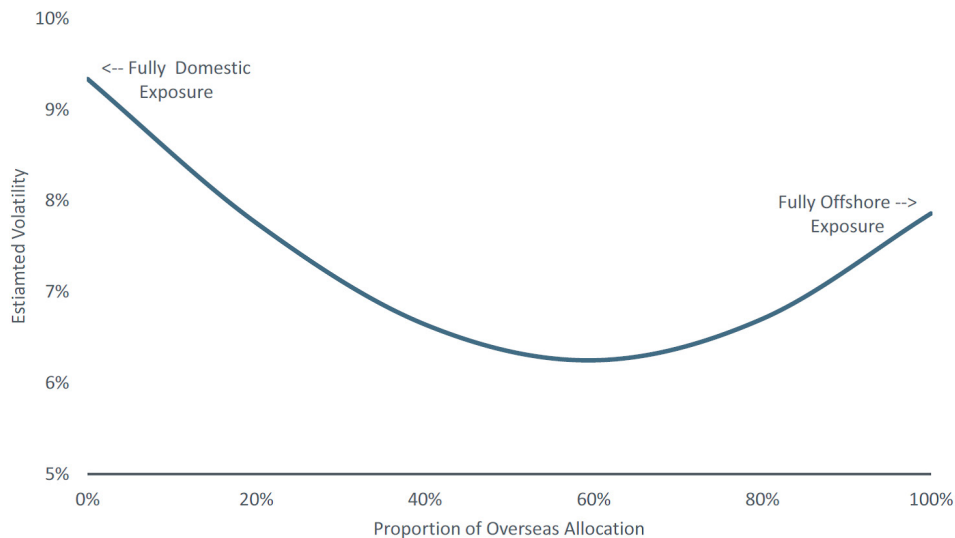
It is clear from Exhibit 2 that the introduction of strategic tilts at the portfolio level can have a material impact on risk and performance. For example, a tilt towards London offices or retail warehouses would have introduced added risk, whereas tilts towards industrial or standard retail assets would have reduced volatility. While the geographic diversification benefits are far greater when investing internationally, real estate asset owners have historically been more inclined to invest directly in local assets. In fact, on average only 13% of a national direct



#### Exhibit 1: UK Segment Performance April 2005 to March 2015

Source: MSCI

Performance numbers calculated using appraisal based indexes



#### Exhibit 2: UK International Diversification Benefit for an Australian Real Estate Portfolio

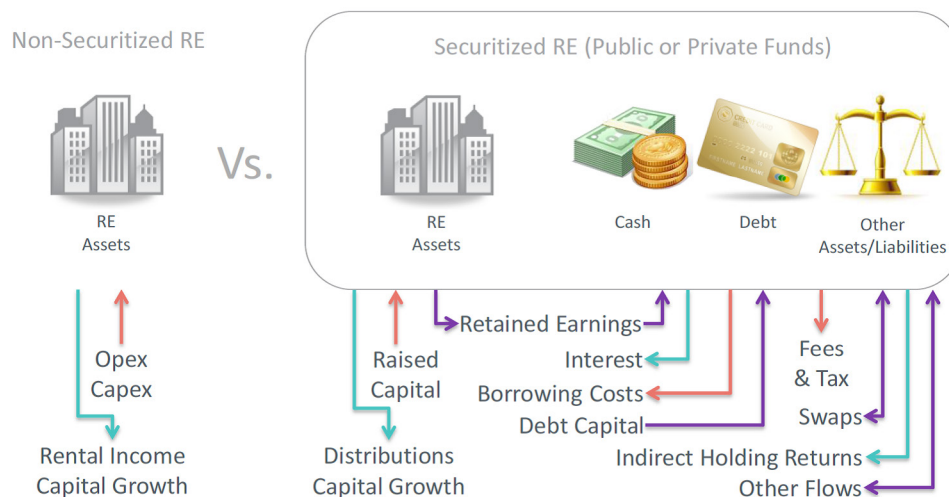
Source: MSCI

Estimated risk of Australian and Global (ex. Australia) direct real estate

real estate market is owned by foreign domiciled portfolios. In some countries such as Japan, home bias can be even greater with 95% of Japanese real estate exposure being domestic. This traditional preference for local assets typically stems from both greater familiarity with local markets and regulations, as well as from a desire to simplify asset management practices. The home-biased focus of real estate investing is starting to change with the globalization of real estate being driven by the largest sovereign wealth and pension funds — many of which have explicit global mandates. Nevertheless, the continued existence of home bias suggests that many investors are foregoing significant risk reduction benefits in their real estate allocations. Taking the example of an Australian real estate portfolio, Exhibit 3 shows how the risk of a fully domestic portfolio lowers with the introduction of offshore assets. An investor only buying local assets would be facing an estimated risk of 9.3%, whereas if

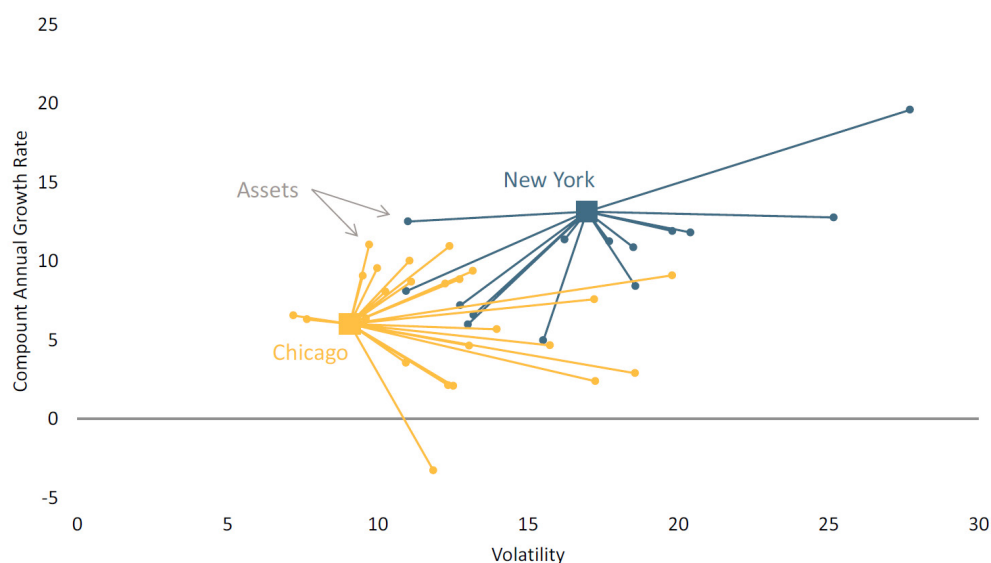
they allocated 60% of their portfolio to overseas real estate, the estimated risk would reduce significantly to 6.3%.

From an investor's perspective, the examples in Exhibits 1 and 2 help demonstrate the importance of maintaining oversight and making the right strategic decisions at the portfolio level. In isolation, it can be hard for an investor to know whether portfolios are aligned with their strategic objectives and if the risks of style drift are being effectively managed. It is in this context that many investors use benchmarking and attribution analysis as a critical element of their risk management process. Deviations from the benchmark provide a gauge of risk-return profiles for portfolios relative to market betas and help identify the structural factors underpinning these relationships. From a risk perspective, sources of volatility can therefore be identified and compared to market norms.



**Exhibit 3: Comparing Direct and Indirect Real Estate**

Source: MSCI



**Exhibit 4: Importance of Asset Selection**

Source: MSCI

### Vehicle Risk

Thus far, the discussion has focused on risk management with direct investment but an additional source of risk exists at the vehicle level when investing indirectly through listed real estate companies, Real Estate Investment Trusts (REITs), or unlisted real estate funds. These vehicles are designed to access the risk and return characteristics of the underlying property assets, and are popular because they are typically more accessible and liquid than direct investment. However, these securitized and commingled fund structures introduce another layer of risks mostly related to the additional assets and liabilities held within the vehicle. Leverage is probably the most significant additional risk driver with indirect real estate. While it enables funds to achieve higher returns during growth periods, it also introduces additional exposure to financial risk. The impact of debt varies with market conditions: it is accretive to fund returns in periods of growth, but is dilutive in a deteriorating market. Because there is a cost

associated with carrying debt, the potential downside impact is stronger and variations in the cost of borrowing can be a source of return volatility.

In addition to leverage, there are several other risk factors that can come with securitized real estate including cash reserves, hedging instruments, fees and taxes, as well as any indirect exposures held by the vehicle itself. In the case of listed vehicles, there is also an exposure to systematic equity market factors to consider. Investors should take into account these additional risk characteristics when adding indirect vehicles to their real estate allocation. The use of indexes such as the IPD Global Property Fund Index can help monitor and control fund level risks. However, the benchmark should be appropriate, covering both fund and listed dimensions. Attribution analysis should then be carried out to explain the contribution of vehicle level factors such as leverage, hedging and fees, to overall performance and risk.



## Asset and Tenant Risk

One of the most important characteristics of real estate is the vast diversity in the underlying asset universe. No two assets are identical as they occupy a different physical location and are distinguished by a range of other characteristics, including function, age and quality. The heterogeneity of real estate stands in stark contrast to traditional assets such as equities or bonds and makes it impossible to create a real estate portfolio that replicates the investible market without actually owning the entire market. The result is that even once strategic decisions have been made at the portfolio level, careful attention needs to be paid to the asset-specific or tenancy risks. Broadly speaking, asset and tenant level risks can include a combination of income and value risks. Income risks are usually measured in terms of vacancy rates, lease lengths, tenant credit quality and covenant strength. Assets with low vacancy rates, long weighted average lease lengths, financially sound tenants and strong covenants are less likely to suffer rental income disruption and are considered less risky.

Value risks can stem from the underlying income risks in an asset but they can also be the result of broader market forces. For instance, legislative changes, environmental performance, technology development and a host of other factors can influence asset values. Because these asset level risks can be so diverse, in many cases asset selection can be as important as market allocation, as shown in Exhibit 4.

Managing these risks can be challenging given the sheer number of variables, but the greater availability of asset-specific data enables more thorough assessments of the relative risks of property specific attributes. Beyond the insights from asset specific data, benchmarking can also be an effective tool as it can improve understanding of how stock selection and management affects performance by making comparisons with market averages for submarkets, employing the discipline of attribution analysis. It provides a stronger awareness of asset operating costs and an indication of the parts of the portfolio where these are affecting net income most significantly relative to industry averages. By assessing how a portfolio compares to a benchmark in terms of factors, including occupancy rates, average lease lengths, reversionary potential, tenant concentration or industry diversification, it becomes possible to find and address potential exposures to asset and tenant risk.

## Conclusion

Real estate is a challenging asset class when it comes to risk management because of its complexities and multiple levels of risk. Nevertheless, with a growing body of research into real estate risk and improved data availability, asset managers and owners should be able to make significant strides in strengthening risk management through their investment process. At the real estate portfolio level, the focus should be on appropriate strategic choices including sector and geographic exposures, as well as leverage. These choices should be aligned with both the overall objectives of the real estate exposure and the actual portfolio itself. It is in this context that real estate benchmarking and attribution analysis can be powerful tools to monitor actual exposure, and ensure strategic and tactical alignment. If investors chose to invest in real estate indirectly, they need to be aware of the additional risks inherent in listed/unlisted vehicles and make sure that the

benchmarks properly reflect these. At the asset and tenant level, benchmarks are again an important tool for controlling risk but rather than focusing on sector/segment exposures, they should focus on asset-specific or tenancy risk like weighted lease terms, vacancy rates and tenant exposure. By identifying the areas or asset or tenant risk where their portfolio exceeds the benchmark, asset owners and managers can drill down to address potential sources of vulnerability.



### Author's Bio

**Max Arkey**  
**Vice President**  
**Product Management**  
**MSCI Real Estate**

Max Arkey works in product management at MSCI Real Estate where he heads up indexes and market information products. These analytics are mission critical to the investment process for 19 of the top 20 largest global asset managers, all the way through to specialized domestic investors.

For further details contact: [max.arkey@msci.com](mailto:max.arkey@msci.com)

## About MSCI

For more than 40 years, MSCI's research-based indexes and analytics have helped the world's leading investors build and manage better portfolios. Clients rely on our offerings for deeper insights into the drivers of performance and risk in their portfolios, broad asset class coverage and innovative research. Our line of products and services includes indexes, analytical models, data, real estate benchmarks and ESG research. MSCI serves 98 of the top 100 largest money managers, according to the most recent P&I ranking.

©2015 MSCI Inc. All rights reserved