Global Property Performance

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Summary

Global property held directly by private investors delivered a total return of 10.7% in 2015, marking the sixth consecutive year of positive performance since the global financial crisis (GFC) and the strongest annual return since 2007. Global performance edged modestly upward from 10.0% in 2014, to reach its highest level since 2007. Ireland continued to lead global markets, though returns moderated from near 40% in 2015 to 25.0% in 2015. Ireland's performance was followed by Spain, at 15.3%, and Sweden, at 14.1%. The UK (13.1%) and USA (12.1%) also provided double-digit returns above their long-term averages and above the global index in 2015.

The cyclical and structural dynamics of real estate attracted a wave of capital in this cycle that has propelled the asset class through a period of strong performance. The appeal was initially cyclical, as depressed prices attracted capital in the immediate aftermath of the GFC. In a typical cycle, tightening real estate yields would slow the flow of capital, but in recent years, record-low bond yields and financing costs have kept spreads attractive. The atypical nature of this cycle continues to keep investors on alert for the inevitable inflection point that, at least in 2015, remained illusory.

Six Consecutive Years of Strong Global Performance

The *IPD* Global Annual Property Index registered a total return of 10.7% in 2015, the sixth consecutive year of strong returns since the GFC, and the best performance since 2007. Global performance has remained remarkably steady through the post-recession years, with fewer than 350 basis points of variation in the headline number since 2010.

Capital Growth Returns to Pre-Recession Levels

Over the long term, real estate generates most of its performance through income, with over

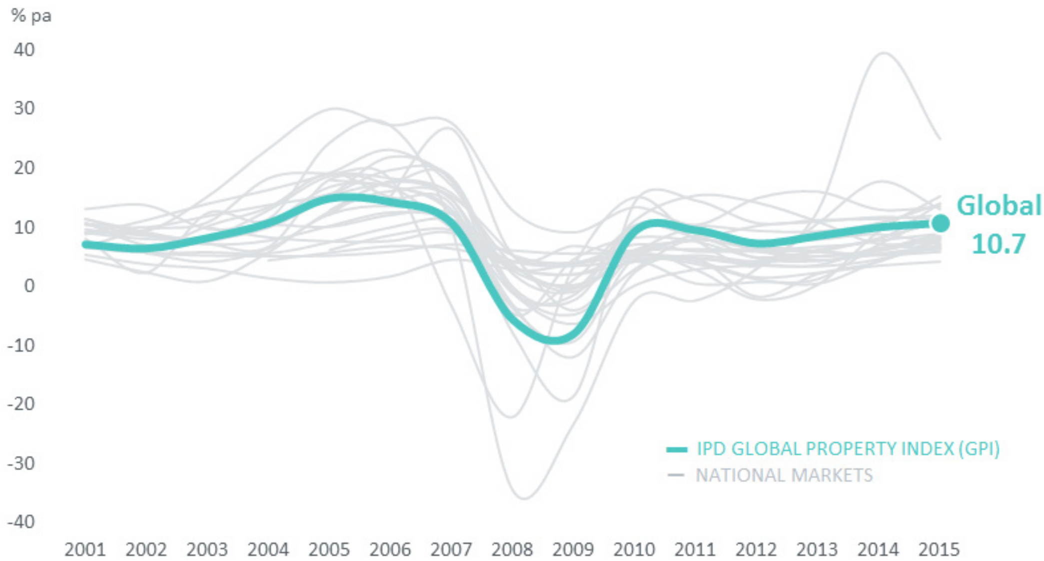

Exhibit 1: Total Returns to 2015 Across National Markets
Source: MSCI; KTI
All property annual returns in local currency

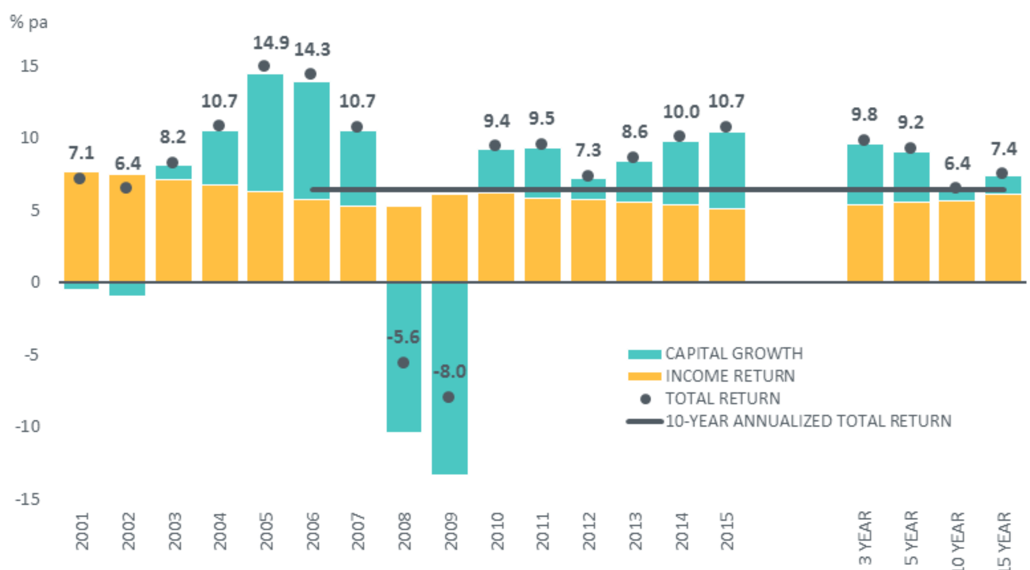

Exhibit 2: Global All Property Total Return History
Source: MSCI; KTI
Including contributing components of total return

80% of total return sourced through the income stream over the past 15 years. In 2015, the global income return narrowed to just 5.1%, with value growth representing more than half of total return for the first time since 2006. This recent trend has been driven by the weight of capital moving into real estate and with it, yield compression. Although income return has fallen over the last five years it held above 5%, still significantly higher than for equities and bonds.

Volatile, Opportunistic Markets Lag Pre-Recession Value Peaks

As investors weigh important tactical considerations for new acquisitions and for existing portfolios, they are likely to reflect on the cyclical position of individual markets. Through the most recent cycle, a few countries have fully recovered value lost during the downturn, including Canada, Sweden, and Australia. Others such as Switzerland and South Korea showed resilience during the worst years of the GFC and had little if any significant losses to be recovered. Large markets like the USA and UK had recovered nearly all of their lost value by 2015 while the year's best performers—the volatile markets of Ireland and Spain—intrigued opportunistic investors, in part, because they remained, even in 2015, well below the capital value levels experienced in 2015.

In the Long View, Real Estate Remains an Income Play

The squeezing of the income yield across so many global markets is notable but it is nonetheless cyclical, not structural, and it obscures the fact that, on average, roughly 80% of the total return in real estate investments is derived from rents, not from value growth. Looking backward and annualizing the components of total return incrementally through the GFC and into prior years,

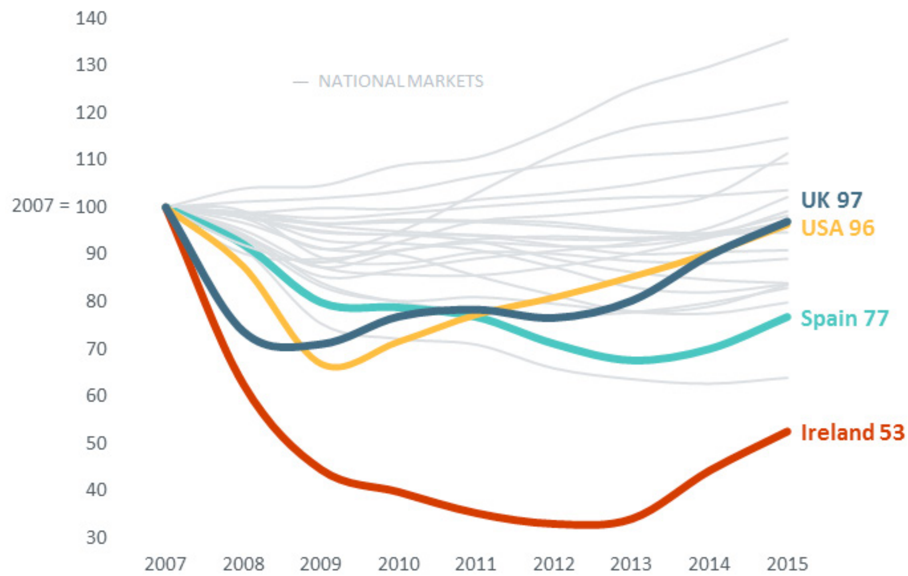

Exhibit 3: Capital Value Growth Across Markets, 2007-2015
Source: MSCI; KTI
2007 indexed to 100

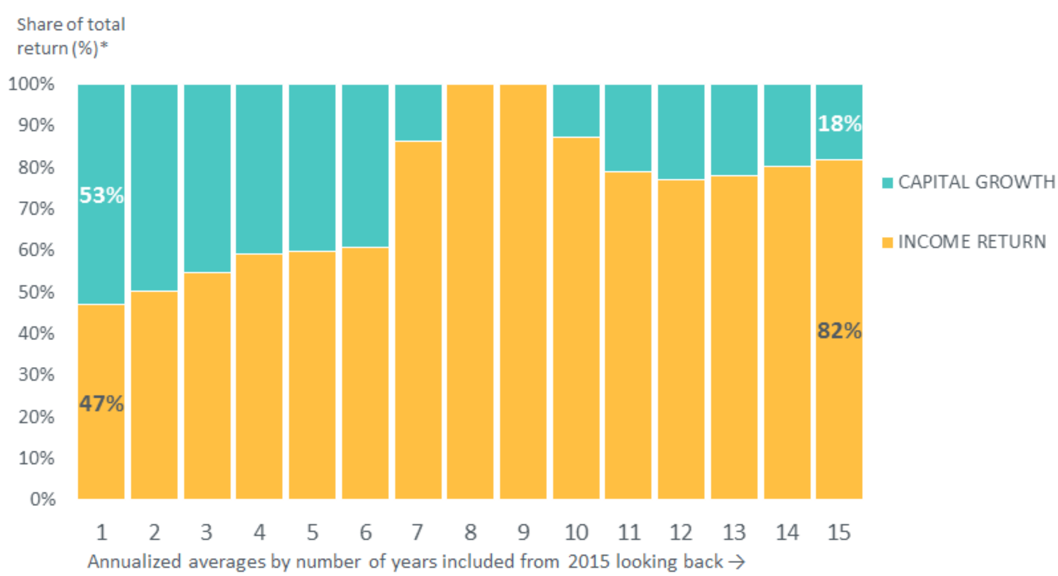

Exhibit 4: Cumulative Contributions to Global Total Return Over Time
Source: MSCI; KTI
Composition of global total return over annualized periods of 1 to 15 years as of 2015
*Note: Approximate shares exclude residual effects. Income return shown as 100% where capital growth is negative.

the components eventually begin to level out, with income return roughly 80% of total performance.

Real Estate Has Performed well in the Post-Recession Period

The attractiveness of wide spreads can be seen more clearly when placed in the broader perspective of the global investment environment. The post-GFC period of capital flows to real estate is part of a long-term trend of investors moving toward alternative investments. Cumulative annual reviews of pension asset allocations in seven key global markets by Willis Towers Watson shows that investors in 2015 allocated 24% to alternatives, a percentage that has moved up incrementally from a level of 5%-7% in the 1990s (Willis Towers Watson, 2016 (and prior years)).

Unlisted direct real estate outpaced both equities and bonds during 2015 by wide margins, though over the longer periods of three, five, and ten years, this degree of outperformance was less visible. A close examination of multi-asset class returns below also shows that unlisted *fund level* real estate outperformed unlisted direct or *asset level* real estate over the one, three, and five year periods where the series is available. The strong performance at the fund level has much to do with the timing of the real estate cycle as funds benefited strongly from the use of leverage at low interest rates. By contrast, the unlisted total returns of directly owned assets are calculated on an unlevered basis.

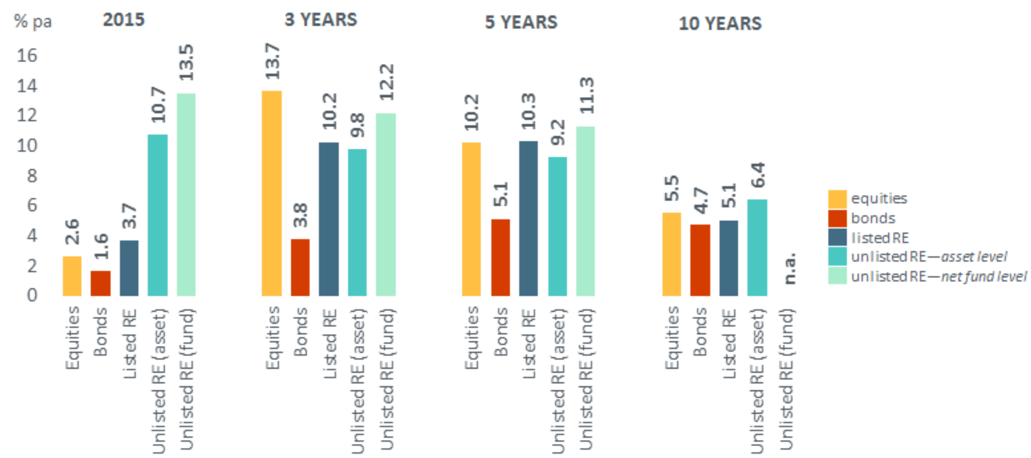

Exhibit 5: Comparative Global Performance across Asset Classes
Source: MSCI World Index (EQUITIES); J.P. Morgan, GBI Global (BONDS); MSCI World Real Estate index (LISTED PROPERTY); IPD Annual Global Property Index (UNLISTED PROPERTY - ASSET LEVEL); IPD Quarterly Global Property Fund Index (UNLISTED PROPERTY - NET FUND LEVEL)
Annualized results at 1, 3, 5, and 10 years

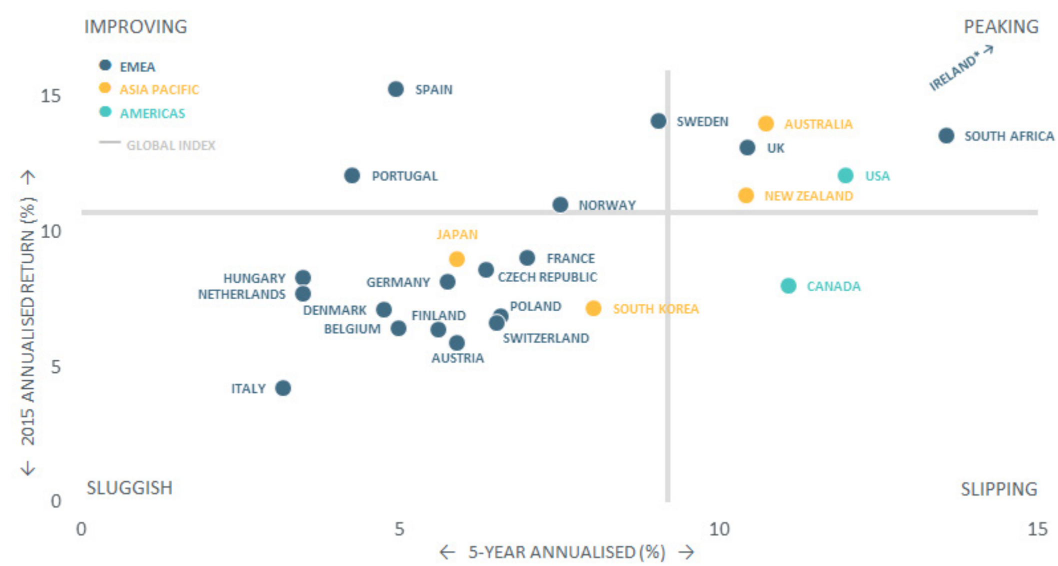

Exhibit 6: Total All Property Returns by Domestic Market
Source: MSCI; KTI
Note: Scale of chart excludes Ireland.

Improving Performance in 2015 Extended into Core Europe

A more explicit way of demonstrating the movements of markets through their cycles is to compare the most recent year's performance against the average over the past five years. This cross-plot, with the axes representing the global index at one and five years belies the recovering markets in continental Europe. Investors in Germany, for example, enjoyed an all property total return of 8.1% in 2015, the highest level achieved in that market in the last 15 years. In a global context, Germany's performance may appear sluggish as the exhibit implies, but some of this may be due to the process of German property valuations which can distort the shape of cycles more than appraisals in other countries (Crosby, 2007). In fact, the majority of European markets performed better in 2015 than they did on average over the past five years.

Even Within Countries, Cities Varied in Performance in 2015

City-specific variations in performance can be significant, even within national markets. In 2015, more than 1000 bps separated the best and worst performing cities in the USA, Canada, and Australia. Even in the smaller, more densely populated European markets, spreads exceeding 500 bps between the top and bottom performing cities in 2015 could be found in the UK, Germany, and Belgium.

For a property investor, the implication is a two-level approach to geographic allocations. The macroeconomic issues of interest rates, currency rates, market transparency, etc., represent the first level of consideration. These are variables that impact national markets, and in many ways, they represent relatively straightforward concepts, with associated risks that can be generally understood and effectively monitored and measured.

Exhibit 7: Performance of Cities within Countries, 2015
Source: MSCI
All property annual total returns

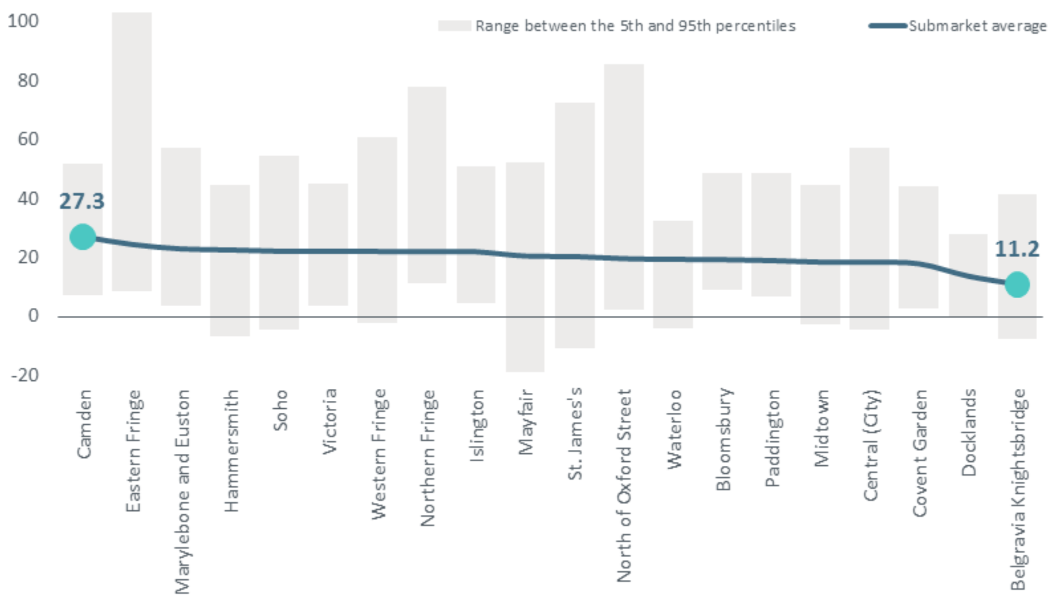

Exhibit 8: Range of Asset Level Total Returns across London Submarkets
Source: MSCI
Annual total return (%), 2015

But from inside a national market, city-level economic structures, strategic location, demographic trends, land use policies and constraints, and supply fundamentals can all lead to differences in cyclical performance and investment opportunities from one metropolitan area to the next. At this subnational level of allocation, the nuances can become more difficult to grasp as well as to measure. The underlying drivers and property type compositions of Las Vegas and Washington, DC, for example, are not necessarily comparable, nor are Tokyo and Sapporo, Munich and Dusseldorf, or Vancouver and Montreal.

And Asset Selection Mattered Too

So if an investor's allocation decisions had led incrementally, first to real estate, then to the UK, then to London, and from there, specifically to Camden, the next step would be the selection of the asset. A review of 2015 total returns of individual assets in each submarket shows a wide range of performance, so wide in fact that the asset performing at the 95th percentile in London's worst performing submarket (Belgravia Knightsbridge) provided a return of more than five times the asset in the 5th percentile in the best performing submarket (Camden).

The drilldown into results in 2015 from the global index all the way to an individual asset in London provides anecdotal evidence to corroborate earlier findings. Previous research suggests that around 50% of the variation in real estate performance relates to property specific factors rather than strategic choices of markets and property types.

Conclusion

In 2015, global real estate experienced its sixth consecutive year of steady, positive returns since the GFC. The headline global return of 10.7% was supported by significant variations in performance and cyclical movements across countries, property types, and cities. These variations represent opportunities for investors and managers but, as markets move through their performance cycles, the challenge of maintaining consistent and strong real estate performance rises. As the results of 2015 show, income returns are being squeezed to record lows across most markets. Meanwhile, strong global performance has recently been pulled up by the two largest countries in the global index, the UK and USA, both of which have a history of volatility in real estate performance. These two markets together contributed 6.4% of the total 10.7% global return in 2015. The UK and USA cannot continue to generate such strong performance indefinitely, and our overview of income security issues in these two markets (along with Sweden and Ireland) illustrates how vulnerable seemingly strong markets can be in their income security.

Against this backdrop, the global appetite for real estate continues to be strong, driven by the wide spreads between real estate and bond yields, even in the UK and USA where spreads, though a bit narrower than a year earlier, still exceeded 250 bps at year-end 2015. The difficulty of gauging the current pricing and prospects for real estate markets represents a major challenge for investors and managers of existing portfolios in their deployment of new capital to real estate. It also relates to more asset-specific considerations such as levels of development and the approach to vacant space, credit quality, and lease length. These challenges are not new for real estate investors, but they become more complex during periods of macroeconomic uncertainty.

Author's Bio

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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.

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