Real estate is one way to improve investment returns

Crestpoint REAL ESTATE INVESTMENTS LTD.

Real estate has generated double-digit returns over the past 15 years. Yet, according to the Pension Investment Association of Canada 2011 Asset Mix Survey, larger Canadian institutional investors, on average, allocate less than 10% of total assets to it, while most medium- to smaller-size investors have no real estate allocation.

As investors seek to achieve their risk and return objectives in a low interest rate and persistently volatile equity environment, real estate is playing a different role in diversified portfolios.

Real estate's current appeal is being driven, in part, by the search for enhanced relative returns given the economic forecasts for both low interest rates and fixed income returns. Real estate is also worth considering because of the strong market fundamentals in Canada and its underlying qualities: steady income returns, low volatility and low correlation to other asset classes. And, it can provide a long-term hedge against inflation.

RISKY BUSINESS

Illiquidity is the most cited risk with real estate investing. However, a key attribute to successful real estate investing is to capture the benefits of the illiquidity premium (the extra return from an investment that takes longer to liquidate). Portfolio liquidity risks can be alleviated in a number of ways, such as relying on other more liquid investments for cash flow needs; investing in open-end funds that can offer greater liquidity flexibility; and incorporating some exposure to more liquid real estate assets (e.g., real estate investment trusts) to manage cash flows.

OUT OF THE FRYING PAN

Rising interest rates imply low or negative fixed income returns, but how do interest rates and other macro factors impact real estate ? Is it not just a case of out of the frying pan and into the fire to switch from fixed income to real estate?

From a theoretical perspective, there are opposing views. One view is that real estate improves returns, since rising interest rates increase funding costs of new construction and the higher costs limit the amount of new supply, which, in turn, supports increased pricing of existing buildings and improves the overall performance of real estate.

The other view is that interest rates and real estate prices are generally inversely correlated. That means, rising interest rates will cause capitalization rates—the ratio between the net operating income produced by an asset and its capital cost (the original price paid to buy the asset) or alternatively its current market value—to increase, which, as a result, will have an adverse effect on real estate values.

At a more practical level, factors that influence property values as a result of changes in interest rates include types of property (macro factors all impact the office, industrial and retail sectors differently); capital structure (the amount of debt in place and whether it is long term or short term, and whether the associated interest rates are fixed or floating); demand and supply (the vacancy rates of a building, the length of the average lease term and whether or not built-in rental escalations are present).

Over the medium term, a well-diversified Canadian real estate portfolio with low vacancy rates, long-term leases and built-in rental increases is expected to deliver an overall net return in the high single digits in a low growth and moderately rising interest rate environment.

Institutional investors are concerned with the impact on fixed income returns in a low or rising interest rate environment. Transferring assets out of fixed income and into real estate is one potential solution to improve expected returns. However, experience suggests that recognizing that there is a problem is not a sufficient precondition for change—even when a credible alternative solution is presented. If it were, then the asset allocation of pension plans and endowment portfolios would have seen more movement toward a greater allocation to real estate before now.

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For further discussion about the ideas discussed in this article please contact the authors:

Colin MacKellar
Executive Vice President
Crestpoint Real Estate
Investments Ltd.
416 864-3137
cmackellar@cclgroup.com

Peter Muldowney
Senior Vice President,
Institutional Strategy
Connor, Clark & Lunn
Financial Group
416-304-6810
pmuldowney@cclgroup.com