AEW Asia Research

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Including the Asia Pacific Region in your Real Estate Allocation

We believe the Asia Pacific region provides investors with a compelling opportunity to add value to their property portfolios and reduce risk while accessing high-growth markets. There are four potential benefits for investors who incorporate this region into their real estate allocation; diversification, access to growth, improved risk-adjusted returns and a wider opportunity set.

Asia Pacific offers access to the world's fastest growing economies. These economies are expected to be the source of the majority of global growth over the next ten years.

The primary reason for including the Asia Pacific region in a property portfolio is diversification. While many investors diversify their equity allocations, typically most real estate portfolios have a domestic bias. Given the local nature of the asset class, we believe the argument for global diversification in real estate is strong. The region offers investors economic and property market cycles that are less correlated than that between Europe and the United States and Asia Pacific also offers greater diversification within the region than Europe. Second, the Asia Pacific region offers access to the world's fastest growing economies. These economies are expected to be the source of the majority of global growth over the next ten years. Third, we believe that adding the region to a property portfolio may lower volatility and improve risk-adjusted returns. Finally, by 2021 the region's property market is expected to be almost 40% of the global institutional commercial real estate universe, offering investors a significantly wider investable universe than they can access in their domestic markets.

DIVERSIFICATION

The risk-reducing benefits of diversification are an important factor to consider when constructing a real estate portfolio and the Asia Pacific region offers economic and property market diversification. Economic cycles are important for real estate investors as GDP growth is linked to real estate income and capital value growth over the long-term. If we examine the correlation between the different regions economies, we can see the benefits of diversification appear strongest in the Asia Pacific region. Our analysis shows that the Asia Pacific region is less integrated into the global economy than its Western trading partners and therefore offers more diversification benefits. Growth in domestic demand is a major factor behind the region's low economic correlation to Europe or the United States, as shown in Figure 1. While trade with Europe and the U.S. has been an important contributor to the region's growth, domestic demand, from both government spending, as well as private investment from both businesses and households, has also played a significant role.

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FIGURE 1: ECONOMIC DIVERSIFICATION AVAILABLE BETWEEN REGIONS
CORRELATION OF GDP GROWTH

	Asia Pacific[1]	Europe[2]	United States
Asia Pacific	1.00		
Europe	0.53	1.00	
United States	0.48	0.61	1.00

Note: Correlation of annual GDP growth at constant prices, 1980–2013
Source: IMF

Moreover, the Asia Pacific region provides investors with greater potential for further diversification within the region than Europe. Figure 2 presents the country-to-country correlation between the major economies in Asia Pacific and in Europe. Both the average and the range of correlations in the Asia Pacific region are lower than Europe, providing even more diversification potential.

FIGURE 2: ECONOMIC DIVERSIFICATION IN THE ASIA PACIFIC REGION

Average: 0.28
Range: -0.07 to 0.67

	Australia	China	Hong Kong	Japan	Korea	Singapore
Australia	1.00					
China	0.22	1.00				
Hong Kong	0.07	0.27	1.00			
Japan	0.13	-0.02	0.52	1.00		
Korea	-0.07	0.17	0.52	0.56	1.00	
Singapore	0.06	0.13	0.67	0.52	0.44	1.00

Note: Correlation of annual GDP growth at constant prices, 1980–2013
Source: IMF

FIGURE 2: ECONOMIC DIVERSIFICATION IN EUROPE

Average: 0.69
Range: 0.36 to 0.84

	France	Germany	United Kingdom	Italy	Spain
France	1.00				
Germany	0.69	1.00			
United Kingdom	0.63	0.36	1.00		
Italy	0.84	0.72	0.74	1.00	
Spain	0.83	0.55	0.68	0.82	1.00

Note: Correlation of annual GDP growth at constant prices, 1980–2013
Source: IMF

[1]Australia, China, Hong Kong, Japan, Korea, Singapore
[2]France, Germany, United Kingdom, Italy, Spain

While economic cycles are important to the long-term performance of commercial property investments, real estate market cycles can decouple from them over the short- to medium-term. Commercial real estate cycles are characterized by the intersection of demand, which is influenced by economic cycles, as well as supply which tends to be “lumpy” and can be constrained by factors such as the cost and availability of labor and materials. Our analysis has shown that commercial real estate in the Asia Pacific region offers investors from Europe and the United States an opportunity to diversify. Figure 3 shows that total returns[3] in the Asia Pacific[4] region have been considerably less correlated to returns in Europe[5] (0.35) and the United States (0.44), when compared with the European to United States correlation (0.78).

FIGURE 3: GLOBAL PROPERTY MARKET DIVERSIFICATION

	Asia Pacific	Europe	United States
Asia Pacific	1.00		
Europe	0.35	1.00	
United States	0.44	0.78	1.00

Notes: Correlations of annual office total returns from 1999 to 2012
Source: IPD, Singapore Urban Redevelopment Authority, Hong Kong Rating and Valuations Department, AEW Research

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ACCESS TO GROWTH

Including the Asia Pacific region in a property investment portfolio can also provide investors with access to growth, as the Asia Pacific economies have grown considerably faster than other economies over recent years and are expected to continue to do so. From 2014 to 2023, the Asia Pacific region is projected to grow 68% (5.3% per annum), a rate that is double the United States (31% or 2.7% per annum) and three times more than Europe (23% or 2.1% per annum). The Asia Pacific region will continue to be the primary source of global growth, representing 53% of growth in global output over the same time period. We believe the region provides a compelling opportunity for investors to add value to their property portfolios while reducing risk and accessing high growth markets.

Our previous paper looked at the fundamental, long-term drivers that are contributing to growth in the region, which include economic growth, urbanization, demographic changes, increased consumption and business growth.[6] Commercial real estate is a factor of production in the local economy, and building values are inextricably linked to economic growth and the success of tenants. As tenants grow, some portion of their excess economic profit will ultimately be capitalized into the value of real estate through higher income. We believe the economic growth in the region provides a strong backdrop for investing in the Asia Pacific commercial property markets that will translate into stronger investment performance.

IMPROVED RISK-ADJUSTED RETURNS

Our analysis of global total returns indicates that adding the Asia Pacific region lowers volatility and can improve risk-adjusted returns. For the period 1999 to 2012, investors that added the Asia Pacific region to a European or United States domestic-only portfolio had lower overall volatility. Figure 4 shows that adding the Asia Pacific region to a U.S.-only portfolio improved risk-adjusted returns.[7] For European investors, country of origin

[3]Total returns in this paper refer to returns from direct property, unleveraged, in local currency and before tax and other costs
[4]Japan, Australia, Korea, Hong Kong and Singapore
[5]United Kingdom, Germany, France, Sweden and Netherlands
[6]Asia Pacific Property: A Primer, June 2013

is important. For instance, investors with a UK-only portfolio saw improved risk-adjusted returns that increased from 0.6% per annum for a domestic portfolio to 0.9% per annum by including the Asia Pacific region.

FIGURE 4: ADDING ASIA PACIFIC IMPROVES RISK-ADJUSTED RETURNS

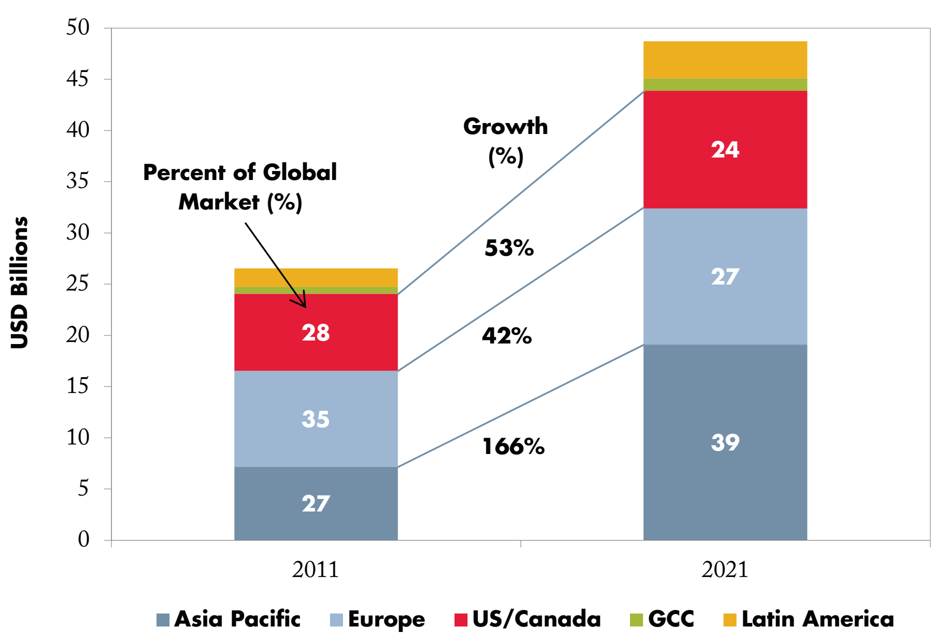
Return per Unit of Volatility	Domestic	Adding Asia Pacific
Global	0.80	
Europe	1.19	1.18
United States	0.70	0.80

Notes: Risk-adjusted returns calculated using annual office total returns divided by their standard deviation for the period 1999 to 2012. Aggregates were weighted by market size
Source: IPD, Singapore Urban Redevelopment Authority, Hong Kong Rating and Valuations Department, AEW Research

WIDER OPPORTUNITY SET

It is also important to consider the investable universe of assets when structuring a real estate allocation. Moving offshore provides a much wider opportunity set to investors than they can access in their domestic market alone and because the Asia Pacific region is projected to be the source of much of the increase in the global property universe, the opportunity set will only continue to expand. Forecasts indicate the Asia Pacific region will represent almost 40% of the global property universe by the end of 2021, up from 27% today. This contrasts sharply with growth in the U.S./Canada and Europe, which are expected to see declines in their share of the global universe from where they are currently. Figure 5 shows the projected change in the stock of institutional-grade real estate by region.

FIGURE 5: SIZE OF GLOBAL INSTITUTIONAL-GRADE COMMERCIAL REAL ESTATE MARKET



Source: Pramerica Real Estate Investors, 2012

[7]We acknowledge property investment risk encompasses many factors, however, for the purpose of this empirical analysis we have restricted 'risk' to the volatility of returns

There is a strong argument that the Asia Pacific region provides a wider opportunity set than investing only domestically. For example, a U.S. investor enjoys the world's largest domestic market, however, this investment universe could be doubled by including the Asia Pacific region. The effect is even greater for European-based investors. The German property market is Europe's largest domestic market, but investors can increase their opportunity set by almost four and a half times by including the Asia Pacific region. Similarly, UK investors can increase their investable universe more than five-fold. The expected growth in the size of the Asia Pacific markets will only exaggerate this effect over the coming years. Clearly there are significant opportunities within the Asia Pacific region for real estate investors, regardless their origin.

CONCLUSION

This paper highlights the potential benefits to investors that include the Asia Pacific region in their real estate allocation; diversification, access to growth, improved risk-adjusted returns and an increased opportunity set. The region offers international investors the opportunity to diversify their portfolio via less correlated economic and property cycles. It also provides access to the fastest growing economies globally, which we believe translates to real estate value. For investors with European or U.S.-only portfolios the region provides the potential opportunity to achieve lower overall volatility and may also improve investors' risk-adjusted returns. Lastly the Asia Pacific region offers the opportunity to access a larger investable universe within which to select investments.

We believe in order to mitigate risk, it is important that investors position their property portfolios for the future, which we believe should include positioning those portfolios to benefit from the expected growth in the Asia Pacific region. Given that real estate is a local asset class and correlations of countries can be low over the long term, the case for diversification is particularly strong for real estate relative to other asset classes.

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