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Ibbotson Associates Global Real Estate Study: Optimizing Portfolios With Global Listed Real Estate Allocations

Executive Summary

The Global Real Estate Allocation: Past and Future

At $4.6 trillion, commercial real estate is a major component of the global investment universe, and investors increasingly are globalizing their real estate allocations. This trend likely will accelerate as the REIT concept spreads around the globe.

The globalization of real estate investment prompts two questions:

- What is the effect of global real estate allocations on the performance of global portfolios, and
- As the European and Asian markets for REITs and other listed real estate grow, how should investors allocate their global real estate portfolios? Specifically, how much should investors be allocating to these newer markets, which historically have delivered lower returns with higher volatility than the North American market?

Ibbotson explored these questions by creating optimized portfolios based on two methodologies:

- Historical portfolio performance using actual investment returns
- Future portfolio performance using forward-looking, expected investment returns

Ibbotson's historical analysis of data for the period 1990-2005 showed global real estate allocations improve returns of a global portfolio, with nearly all of that increase coming from North American real estate investment.

The forward looking analysis indicated that, while North American real estate should continue to be more than half of the total real estate allocation in an optimized global portfolio, future allocations to European and Asian real estate should increase.

As compared with the optimized portfolio based on historical data, the European allocation in the optimized forward-looking portfolio increased five-fold; and the Asian allocation quadrupled.

Risks and Returns

Ibbotson charted risks and returns for various asset classes for the period 1990-2005 and constructed optimized portfolios of moderate risk (defined by a 10 percent standard deviation) with and without global listed real estate (represented by the FTSE EPRA/NAREIT Global Real Estate Index, with its North American, European and Asian components).

An optimized portfolio including an allocation to global listed real estate of 19.7 percent produced an average annual return of 10.98 percent—111 basis points above the 9.87 percent return for an optimized portfolio without the global real estate allocation.

The optimum real estate allocations by region placed the bulk of investment in North America, due to its superior returns and lower volatility, with minimal allocations to Europe and Asia:

- North America: 17.3%
- Europe: 1.6%
- Asia: 0.8%

Modeling the Future

The future performance of global real estate, however, may not be a mirror image of the past. Consequently, Ibbotson constructed estimates of future investment returns, including expected returns from global real estate investment, by blending historical returns with expected future returns based on levels of risk (measured by standard deviation) for each of the various asset classes in the portfolio. The assumption behind the blended expected returns is that, over time, higher levels of risk are commensurate with higher returns.

Ibbotson's optimized forward-looking portfolio including global real estate produced a 9.6 percent average annual return compared with the 10.98 percent return for the portfolio based only on historical data.

Additionally, the real estate allocation of the optimized forward-looking portfolio contained more balanced allocations to the real estate markets around the world. More than half of the total 23.3 percent real estate allocation still was invested in North America. But one-third of the forward-looking real estate allocation went to Europe and the remainder to Asia.

- North America: 12.1%
- Europe: 7.8%
- Asia: 3.4%

Implications for Investors

Ibbotson's forward-looking results point to the growing importance of the European and Asian real estate markets for global investors—but also to the continuing importance of the North American market, and the overall importance of real estate investment in a globally allocated portfolio. They also may indicate that future investors may be required to assume more risk to achieve returns comparable to historical returns.

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