FOCUS ON THE ECONOMY AND REAL ESTATE

BENEFITS AND ISSUES IN GLOBAL REAL ESTATE INVESTING: A REVIEW OF THE RESEARCH

By Raymond G. Torto, CRE

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Over the last two decades deregulation, growth, integration of financial markets, and significant political and economic reforms around the globe have propelled a dramatic increase in international investments. The level of international investment varies, however, significantly across countries. For example in 1993 U.S. pension funds had 4.5% of their assets invested in international equities (Bajtelsmit and Worzala, 1995) while U.K. funds had 25% of their funds in international investments (Sweeney, 1993).

Most international investments have focused on stocks and bonds and to a significantly smaller extent on real estate. Some institutional investors, particularly, from United Kingdom, the Netherlands, and more recently from Japan have established traditions in international property investment. The level of participation of U.S. investors in international real estate investments, however, has been minor although in the recent years there has been a growing interest in this type of investment. With financial deregulation, the integration of global markets, and the emergence of global real estate services companies, this perspective is changing and investors are taking a new look at the possibilities for international property investments.

BENEFITS OF INTERNATIONAL REAL ESTATE INVESTING

International real estate investments may help investors increase returns or reduce risk. U.S. investors may increase their returns by investing in international properties with prospects for better performance than domestic assets. For example, during the period 1985-1995 U.S. investors, had they invested in office properties located in U.K., Australia or Canada, as opposed to domestic assets, they would have earned a significantly higher return. Paggliari, Webb, Canter, and Lieblich (1997) found that office property investments in the U.S. during that period provided a zero average annual return while similar investments in U.K., Australia, and Canada provided an average annual return as high as 12.4%, 8.1%, and 4.5%, respectively.

International real estate investments can help investors reduce risk in two ways. First, by investing in foreign markets that are less risky. For example, Paggliari, Webb, Canter, and Lieblich (1997) found that office investment performance in the U.S and Canada was considerably less volatile than office investment performance in Australia and the U.K during the period 1985-1995. Second, investors can reduce risk simply by diversifying their portfolios with the inclusion of foreign assets whose performance is likely to be minimally correlated with performance of domestic assets. Such low correlations are attributed to differences in behavior over time stemming from different market structures and idiosyncratic economic shocks.

Research in the last thirty years has shown that international investing does provide diversification benefits. However, only recently has attention been turned towards international real estate investments within a mixed-asset portfolio. The results of the research with respect to the diversification benefits of direct equity investments are mostly encouraging.

Some researchers (Worzala and Vandell, 1995; Sweeny, 1993) have found that international real estate provides diversification benefits when included in mixed-asset portfolios. Such benefits were found to be reduced but not eliminated by exchange rate fluctuations. Chua (1999) also found that international real estate does have a viable role to play in global mixed-asset portfolios even after correcting for the higher taxes, transaction costs and management fees incurred when investing in real estate.

Torto Wheaton Research has prepared a study that also concludes that global real estate investments can help U.S. investors better diversify their portfolios. The study focuses on 21 cities on five different continents and uses historical rent series to calculate pair wise correlation coefficients in order to gauge the extent to which movements in these markets during the period 1975-1997 were synchronized.

Each annual series was first converted to U.S. dollars at its historical exchange rate to demonstrate what these income streams would mean to an American investor, thus incorporating the impact of exchange rate risk. To remove complications from inflation in other countries, all rent series were also adjusted for U.S. inflation. The estimated correlation coefficients are presented in Table 1. As seen from this table while the correlations among North American cities is quite high, the correlations among European and Asian cities is somewhat lower. The lowest correlations, however, are seen between North American cities and cities in Asia and Europe, demonstrating that these combinations would have provided the greatest diversification benefits.

Table 1 shows that diversifying investments only across major markets in North America still carries a high degree of risk that cannot be diversified away. The average correlation among markets in North America is 0.77. This high correlation is the result of somewhat similar construction cycles in the North American markets, as well as common economic influences. A relatively high average correlation can also be observed among major mar-

Table 1

	Los Angeles	New York	Chicago	Dallas	Toronto	Amsterdam	Geneva	London	Brussels	Frankfurt	Madrid	Paris	Singapore	Hong Kong	Tokyo	Jakarta	Melbourne	Sydney	Auckland	Rio De Jainero	Sao Paulo
Los Angeles	1.000																				
New York	0.939	1.000																			
Chicago	0.908	0.967	1.000																		
Dallas	0.801	0.745	0.768	1.000																	
Toronto	0.718	0.645	0.570	0.216	1.000																
Amsterdam	-0.498	-0.617	-0.633	-0.433	-0.220	1.000															
Geneva	-0.281	-0.226	-0.264	-0.777	0.366	0.217	1.000														
London	0.369	0.392	0.343	-0.149	0.794	0.047	0.691	1.000													
Brussels	-0.749	-0.802	-0.825	-0.853	-0.189	0.807	0.610	0.123	1.000												
Frankfurt	-0.603	-0.674	-0.728	-0.811	0.030	0.702	0.666	0.208	0.947	1.000											
Madrid	-0.034	-0.127	-0.195	-0.465	0.603	0.469	0.698	0.635	0.633	0.782	1.000										
Paris	-0.343	-0.390	-0.444	-0.748	0.345	0.568	0.855	0.559	0.829	0.909	0.911	1.000									
Singapore	-0.303	-0.404	-0.461	-0.174	-0.079	0.402	-0.061	-0.121	0.386	0.443	0.302	0.229	1.000								
Hong Kong	-0.611	-0.665	-0.704	-0.600	-0.274	0.646	0.321	0.080	0.654	0.551	0.281	0.437	0.497	1.000							
Tokyo	-0.285	-0.309	-0.376	-0.762	0.434	0.323	0.912	0.587	0.707	0.822	0.855	0.933	0.100	0.316	1.000						
Jakarta	0.612	0.424	0.395	0.540	0.536	0.086	-0.249	0.265	-0.252	-0.100	0.281	-0.033	0.359	-0.035	-0.119	1.000					
Melbourne	0.443	0.445	0.367	-0.125	0.897	-0.137	0.646	0.875	0.053	0.253	0.733	0.570	0.010	-0.047	0.648	0.386	1.000				
Sydney	0.159	0.071	-0.021	-0.277	0.702	0.193	0.576	0.729	0.336	0.485	0.804	0.653	0.442	0.365	0.671	0.428	0.831	1.000			
Auckland	0.341	0.473	0.468	-0.072	0.587	-0.247	0.589	0.862	-0.123	-0.105	0.240	0.255	-0.346	-0.116	0.346	-0.042	0.670	0.415	1.000		
Rio De Janeiro	-0.045	0.006	0.010	-0.451	0.487	0.212	0.763	0.830	0.401	0.426	0.655	0.681	0.154	0.377	0.634	0.035	0.725	0.725	0.721	1.000	
Sao Paulo	-0.280	-0.309	-0.345	-0.617	0.370	0.498	0.749	0.659	0.694	0.748	0.825	0.861	0.464	0.595	0.763	0.122	0.619	0.799	0.386	0.880	1.000

kets located within Europe. On the contrary the average correlation among markets in Asia is considerably lower—0.19.

The correlations in Table 1 suggest that there is more to be gained in cross-continental diversification, specifically North America and Europe or North America and Asia. For example, market performance in Hong Kong exhibits an average -0.57 correlations with market performance in the North American markets, while Frankfurt and the North American markets exhibit an average of -0.56. These statistics show that rents in many foreign markets do not move with rents in North American markets, yet again suggesting that holding assets in various global markets may help diversify away some systematic risk.

Contrary to these results that do advocate direct investments, a few other studies found that Japanese and British investors did not gain from diversifying their portfolios with U.S. real estate (Ziobrowski and Curcio, 1991) even after mitigating for currency risk (Ziobrowski and Boyd (1991).

Paggliari, Webb, Canter, and Lieblich (1997) studying the different components of equity real estate returns in four countries (U.S., Australia, Canada and United Kingdom) find that space markets display lower correlations between countries than do capital markets or capitalization rates. They attribute such lower correlations to the fact that space markets comprise more idiosyncratic risk as local customs, regulations, and business practices may cause space markets to behave differently from one country to the other, while the price of capital is increasingly set in international markets.

CONCLUDING REMARKS

Despite the significant degree of integration of world economies there is still significant cross-country and cross-continent divergence in real estate market and property performance. Thus, global property investing may provide considerable diversification benefits and opportunities for increased returns. As the world economy is becoming more and more integrated, the avenues of international real estate investing are becoming wider. Although many of the traditional risks associated with non-domestic property investments remain, the globalization of real estate services companies may help investors get a better handle of these risks and hopefully turn them into advantages.

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ABOUT THE AUTHOR

Raymond G. Torto, Ph.D., CRE, is principal at Torto Wheaton Research in Boston, where he specializes in market research analysis and economic forecasting. He has been a member of The Counselors of Real Estate since 1988. (E-mailL RTorto@TortoWheatonResearch.com)