The case for international real estate investment: Why do domestic investors venture overseas?

There is no denying that the UK property market has been an exciting playground for real estate investors over recent years. Landlords have enjoyed rebounding rents on the back of widespread economic recovery, coupled with strong price inflation thanks to large waves of capital targeting the sector. Market returns in excess of 10% p.a. over the past 5 years have kept property investors busy in their home market.

However, with domestic and global headwinds well reported, many are predicting that the good times could soon stop rolling. We at DTZ Investors are forecasting total returns from UK real estate to slow considerably in the period 2016 – 2020. Such subdued UK predictions are encouraging increasing numbers of traditionally domestic-focused property investors to consider opportunities overseas.

The rationale for institutions to invest outside their domestic economy is largely two-fold; to ***diversify risk*** *and to* ***target better returns****.*

Diversification benefits of an international approach:
Real estate supply and demand is heavily influenced by local regulatory, tax and planning frameworks and regional socio-economic and political environments. Thanks to cultural differences and variations in political beliefs and strategy, international real estate markets are likely to continue to move asymmetrically, just as they have done in the past.

Low or negative correlations between some real estate markets mean that global portfolios can potentially benefit from a powerful diversification effect through an improvement in risk/return profile.

Adding assets to a diversified portfolio that have correlations of less than one with each other can decrease portfolio risk without sacrificing return. On a regional basis, selecting real estate investments in Asia Pacific should provide the best diversification benefits alongside UK real estate exposure (Figure 1). Asia Pacific has displayed the weakest correlation to the UK over the past 15 years, at 0.28. Due to closer trade links and similar monetary policies Europe and the US are more closely aligned.

Figure 1. Regional 1 yr total return correlations (2000-2015)

	UK	Europe	US	APAC
UK	1.00			
Europe	0.40	1.00		
US	0.46	0.91	1.00	
APAC	0.28	0.79	0.63	1.00

Source: Cushman & Wakefield Research, DTZ Investors

Figure 2 below shows the annual total returns delivered by the UK, European, Asian, US and Global real estate markets since 2000. **Global real estate returns have been much less volatile, smoothing out the extreme peaks and troughs experienced within the regional markets during certain periods.**

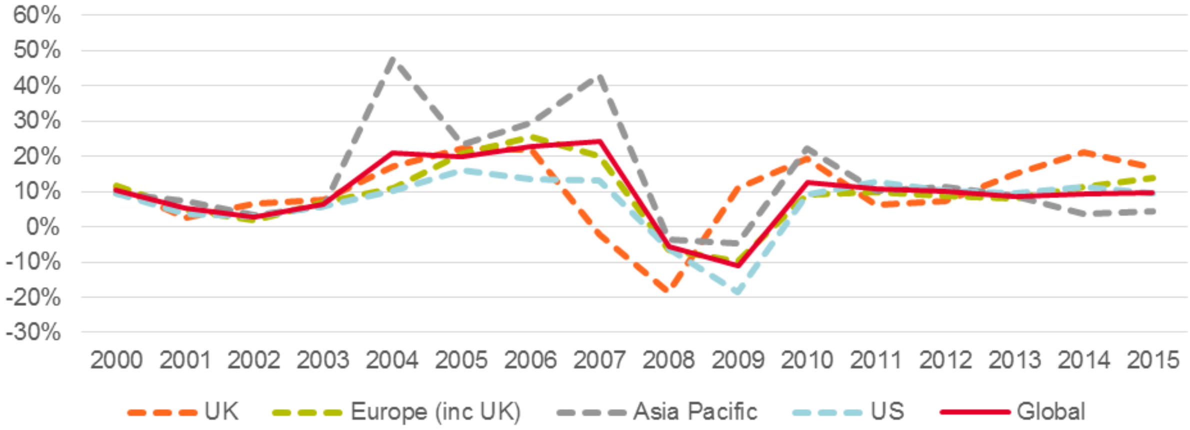
The Sharpe ratio is a measure for calculating risk-adjusted return, and is the average return earned in excess of the risk-free rate per unit of volatility or risk. The greater the value of the Sharpe ratio, the better the risk-adjusted return. As shown in Figure 3 an investor investing exclusively in the UK since 2000 would have experienced a Sharpe ratio of 0.67. **By expanding the investible universe to include the wider European, US and Asian markets, an investor could have increased their Sharpe ratio to 1.02 and achieved a better return on a risk-adjusted basis over the past 15 years.**

Figure 3. Sharpe ratios (2000—2015)

UK	**0.67**
EUROPE	**1.01**
APAC	**0.91**
US	**0.81**
GLOBAL	**1.02**

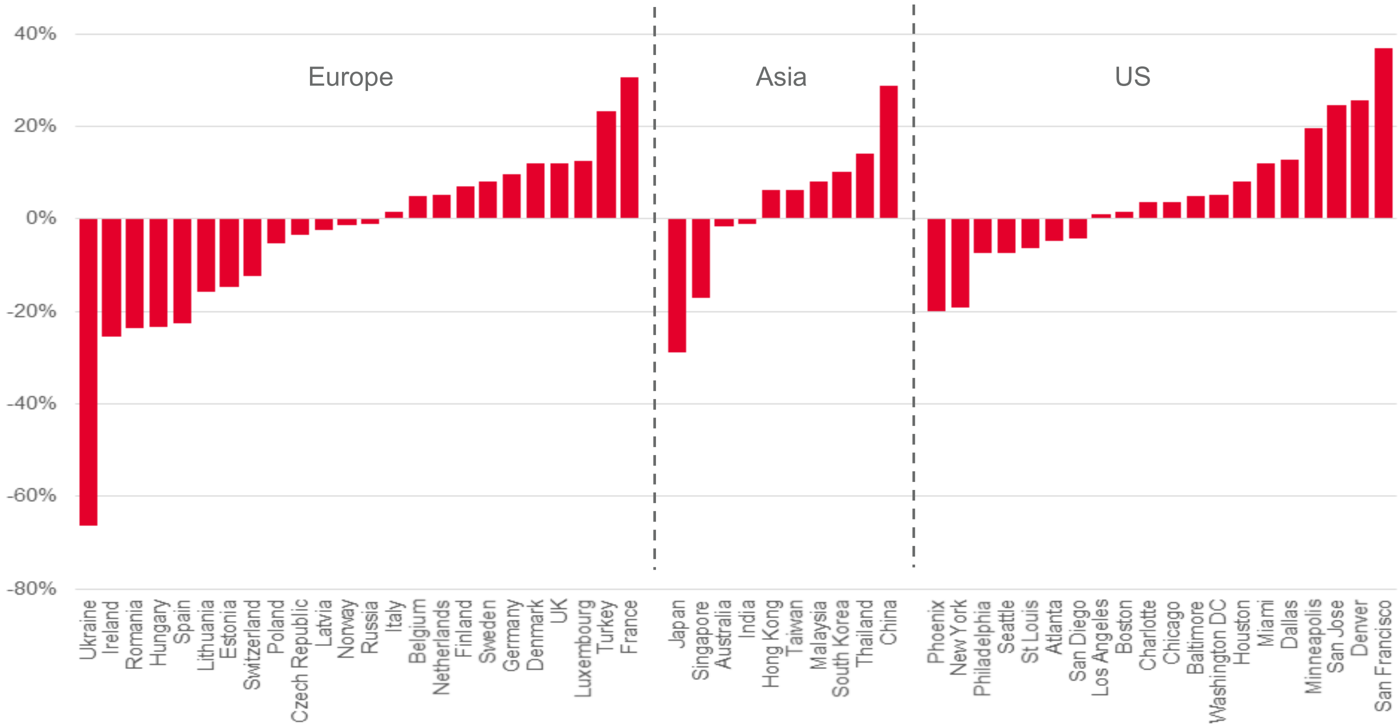
Source: Cushman & Wakefield Research, DTZ Investors

Figure 2. Annual total returns (2000-2015)



Source: Cushman & Wakefield Research, DTZ Investors

Figure 4. All Property prime rents Dec 15 vs 2006-2009 peak



Source: Cushman & Wakefield Research, DTZ Investors

Strong potential in international markets

The inability of real estate supply to perfectly react to changes in demand causes cyclicality in real estate markets. During periods of expansion, increasing occupier demand is not met by a corresponding increase in supply due to the time it takes developers to obtain planning permission and build new stock. In response to increasing rents caused by the supply/demand imbalance, developers significantly increase their activity. The supply pipeline tends to overshoot at the market peak and then follows a period of contraction as the glut of space is slowly let up.

The development tap is consequently turned off as rents soften and so the market recovers before the cycle starts again. This natural ebb and flow to international real estate markets offers investors with a global investment remit the opportunity to target those markets in a growth phase and avoid those in a state of decline.

Figure 4 shows current international rental levels compared to their peak before the global recession. The graph splits the markets by region, with those markets that have recovered the most towards the right hand side of their respective regions.

As demonstrated, not all markets have recovered to the same extent. Some market rents such as those in Ireland, Spain and Singapore are still at large discounts to where they were before the crash. Other markets on the other hand have already surpassed their previous rental peaks and in some instances by significant margins. What is clear regarding the UK is that its real estate cycle is more mature than other global markets in terms of rental recovery. This suggests that from this point in the cycle investors could benefit from stronger rental growth outside of the UK real estate market by selecting those economies further behind the UK in terms of economic and real estate recovery.

With the UK market accounting for just 5% of global real estate and forecasts looking unimpressive, can investors afford to keep ignoring international opportunities?

Figure 5 shows our forecasts for total returns in selected markets based on rents and capital values as at Q1 2016. **Favourable demographics, political reform, and a growing middle class point towards high returns emanating from India.** We anticipate real estate returns of over 10% p.a.

In terms of more developed markets, we are predicting high single didget returns from North America, Australia and Spain - indicating now could be the right time for investors to expand their investible universe beyond UK territory.

About DTZ Investors

DTZ Investors advise clients on their international real estate strategies. We are part of the Cushman & Wakefield Group, the second largest real estate services firm in the world. Cushman &Wakefield has over 43,000 employees in more than 60 countries. Our research function of over 200 staff worldwide monitors over 200 global property markets.

We enjoy excellent local market knowledge and access to deal flow which puts us out in front of our competitors when it comes to developing and implementing our clients' international investment strategies.

Figure 5. Prime All Property forecasts (2016-2020)

Country	Forecast total return	Country	Forecast total return
India	13.7%	Japan	5.4%
N. America	9.5%	Denmark	5.4%
Australia	8.6%	Netherlands	5.2%
Spain	8.4%	UK	5.0%
China	8.3%	Norway	4.8%
Ireland	7.5%	Germany	4.8%
Malaysia	7.5%	Finland	4.4%
Belgium	7.3%	Sweden	4.3%
Poland	7.2%	France	4.2%
Turkey	6.7%	Singapore	3.1%
Italy	6.5%	Hong Kong	2.1%
South Korea	6.0%	Taiwan	2.0%

Source: Cushman & Wakefield Research, DTZ Investors (Q1 2016)

Figure 6. The Cushman & Wakefield Group office locations

Source: Cushman & Wakefield

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