Bonding with property

A recent study by EPRA indicates that real estate securities are good diversifiers for investors in bonds. **Steve Hays** reports

Property stocks offer good diversification benefits across a range of major investment asset classes, but appear to be particularly interesting to investors in government bonds, an extensive correlation study commissioned by the European Public Real Estate Association (EPRA) shows.

“Correlation, or to be more precise lack of correlation, lies at the heart of many institutions’ asset allocation policy. EPRA wants to encourage a wider understanding of how real estate and real estate securities perform,” says Paul Rivlin, chairman of EPRA’s ‘Broadening the Investor Base Committee’ and joint chief executive of European real estate investment banking at Eurohypo.

The research, published under the title: ‘EPRA Broadening the Investor Base Study – Correlations of Property Stocks with other Asset Classes’, was carried out by Professor Steffen Sebastian of the International Real Estate Business School at the University of Regensburg in Germany.

The study investigated rolling correlations in periods of five years for the quarterly returns of the FTSE EPRA/NAREIT Global Real Estate index series against three classical asset classes: equities, bonds and money (treasury bills), and five alternative assets classes, including direct real estate, emerging market stocks, hedge funds, private equity and commodities.

The association’s European total return index of property stocks was included in the study, as well as national indices for the US, UK, Australia, France, Sweden and the Netherlands.

Large economies such as Germany, Italy and Spain were not included, because the size of the real estate equities sectors, relative to their broader stock markets, is quite small. For example, real estate represents only 0.6% of the market capitalisation of the German equities market and 0.58% and 1.91% of the Italian and Spanish markets.

“For all asset classes, we see that property stocks show correlations significantly below 1.0 — and in some cases we got negative readings — which indicates the good diversification benefits of investing in real estate equities for a mixed asset portfolio,” Sebastian says.

“The story is clear that from 2000 onwards the correlation between the FTSE EPRA/NAREIT Global Total Return Index for property stocks with bonds became quite negative, after being relatively stable throughout the 1990s,” he added.

“It is not possible to draw a direct causal link from a correlation study, but this is probably related to the decline in global interest rates after 2000. It does seem, however, to make property stocks an interesting diversifier for conservative bond investors for, say, 5% of their portfolios.”

The correlations between the FTSE EPRA/NAREIT indices and bond indices for Germany, the UK and US were mostly positive until the end of 1998, when there was a sharp decline in figures, which became mostly negative after 2000. Since 2003 there has been a steady climb back in correlations between the two markets.

Sebastian says the average correlation between property sector stocks and stock market indices is low at about 0.5 over the period of the study between 1994 to 2006. This makes listed property a good diversifier towards general equities, but he adds that there appeared to be a trend towards greater correlation of real estate shares and stock indices in the past few years.

“The correlation between the EPRA Euro Index and stocks has fluctuated quite a lot and was quite high in the 1990s, but it appears to be stabilising towards the 0.5 area like the UK. One interpretation could be that the European market is getting more mature, as property stocks have become quite fashionable and equity analysts are focusing on them more, accompanied by the increase in capital flows into the sector,” he says.

“Property stocks have for a long time been a specialist area and it now appears they are becoming a classical investment.”

Correlations between emerging market equities in Europe, Asia and Latin America are currently strongly positive with all the FTSE EPRA/NAREIT indices, except for the Australian index. Previously there were fluctuating patterns in the relationship between these two areas from 1995 until 2006.

While correlations between the association’s Global, European and Netherlands indices have been steadily strong, there were declines in levels, and even negative correlations with emerging markets for the US (around 1997), UK (2001) and Sweden (1998), followed by a constant climb until 2006.

The relationship between property equities and the underlying direct real estate is a perennial issue of debate in the investment world and the EPRA study doesn’t give a definitive answer on the correlation between stocks and bricks and mortar.

“There’s a whole bunch of literature on whether property companies are leading or lagging the direct market, which hasn’t really produced any definitive conclusions. The French, Dutch and Swedish EPRA indices’ correlations fluctuate around zero. For the remaining indices we’ve observed increasing correlations with direct real estate from 1999 until now. Currently all correlations are positive, ranging between 0.15 for Sweden and 0.55 for Australia,” Sebastian says.

The correlation pattern between real estate equities and hedge fund investments is similar to emerging markets and is currently strongly positive, after a period of decoupling with US property between 1996-1998 and the UK from 2003-2004. The relationship has, in general, been remarkably steady with a mean of 0.76 against the FTSE EPRA/NAREIT Global Index.

“It seems that as an asset class, investment. “

Commodities were the final alternative asset class examined by the Regensburg team and the correlations with property stocks were mostly negative. The lowest correlations were with Australian real estate equities in a range between -0.3 and -0.5.

Sebastian says: “Commodities have almost nothing to do with the property companies, except probably very indirectly through building materials such as copper, but there is of course a relationship between economic cycles and direct real estate and raw material markets.”

Paul Rivlin says EPRA intended to repeat the study on a regular basis so as to provide a firm basis for the understanding of diversification and correlation benefits from holding real estate assets and securities.

“The study of correlation (and hence of diversification) shows how useful real estate and real estate securities are as an asset class in a widely spread portfolio and EPRA is pleased to have the opportunity to work with the investment market in deepening understanding,” he concludes.

Steve Hays is a founding director of Bellier Financial Marketing based in Amsterdam.

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