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Global property investment

Broadening horizons through diversification

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Aberdeen

Contents

Tokyo Skyline.

Global property investment

Global or local?

Property has long been considered a mainstream asset class for institutional investors. However, for most there has been a strong home-bias, with high exposure to domestic markets. Increasingly, we believe investors are looking toward global property markets as a way to improve potential risk-adjusted returns and diversification of their property portfolio.

The step from domestic to global property investment, however, is not a trivial one and in some cases it may not be an appropriate solution. We believe the following three steps provide some insights into global property markets and also a framework for investors to understand better whether it might be a suitable approach for them.

1. The potential benefits of investing globally

This is often the starting point when considering investing globally in property, but when taken in isolation, they may not be sufficient to support embarking on such a program.

2. Consider starting with a global portfolio

The reality for most investors is that they start with a domestic property portfolio. However, theoretically, investing globally may deliver potentially higher risk-adjusted returns.

3. Entry points and home bias

We believe Investors should consider how they intend to access global and domestic property markets as this will determine whether in practice a global or domestic solution makes the most sense, or, more likely, whether a blend of the two is more appropriate.

1. Potential benefits of investing globally

i) Wider opportunity set

In our opinion, for most investors, a step outside of their domestic property market can rapidly expand the opportunity set (and potentially improve diversification[1]) as local markets typically represent only a fraction of the overall property universe.

Taking an example, such as the property markets for Australia and Canada, we can see in Figure 1 that more than 95% of the global property market is outside of the domestic market. As highlighted in Figure 2, even the largest single regional market, the Americas, makes up only around 40% of the global property market.

Increased opportunity set - size (mature markets)

Share of global property market (%) in 2011

Figure 1

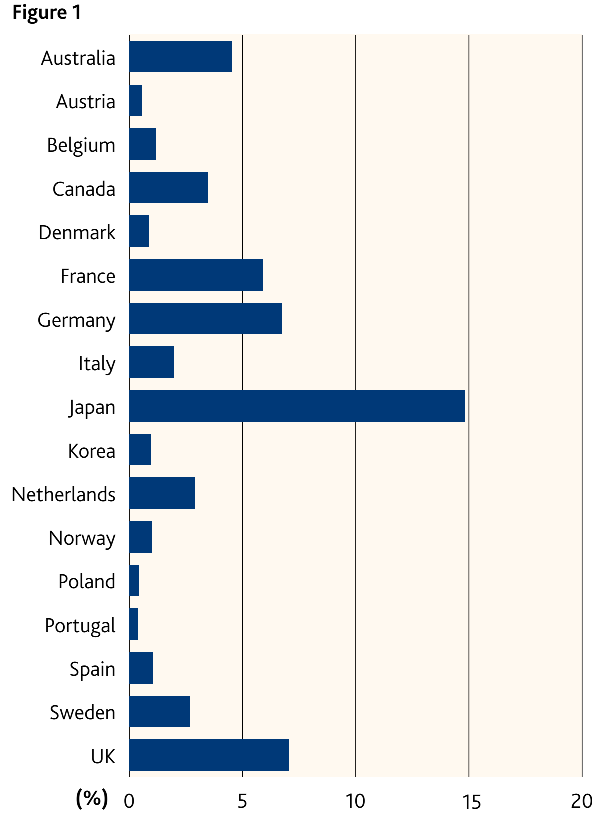
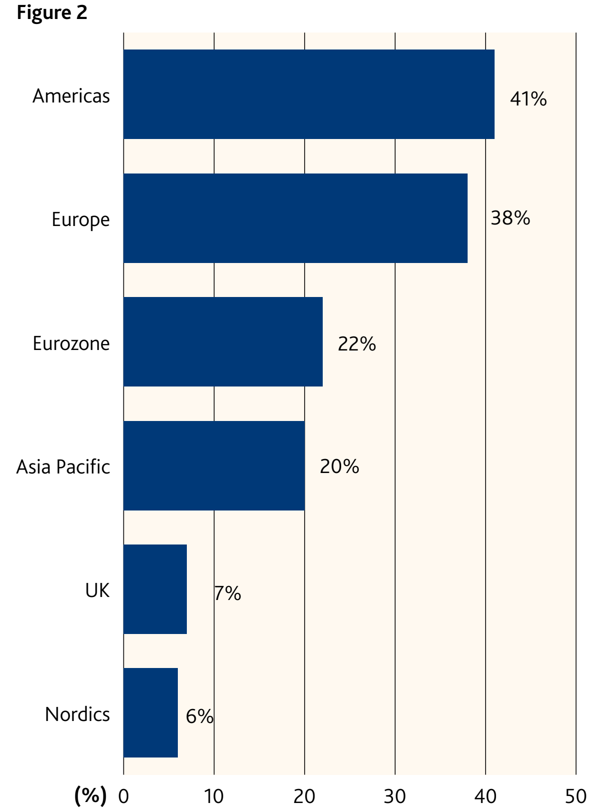


Figure 2



Source: IPD 2012, does not add to 100% due to countries not shown and double counting of Finland in eurozone/Nordics
For illustrative purposes only.

[1]Diversification does not ensure a return or protect against a loss in a declining market.

ii) Access to sector and strategy opportunities

Not all domestic property markets are alike. For instance, in some countries institutional investment in specific property sectors is possible, whereas in other countries it is not. The clearest example of this is the residential sector where a typical institutional portfolio may have between zero and over 50% in the sector, depending upon the country. Another, less extreme, example is the hotel sector. Emerging sectors like healthcare, seniors' housing and student accommodation are available in some countries and not others.

In addition to the range of sector opportunities that exist in some property markets, a broad spectrum of property investment strategies are also possible in some markets. Perhaps the most obvious example of this is property development in emerging markets. This opportunistic style of investment may not be as readily available in more developed markets. Other examples include the ability to access markets with different tenants or different lease structures.

iii) Potentially higher returns

In the short-term, experienced investors may consider their property market to offer poor value and this often starts the drive to look for opportunities outside of their domestic market. Implicit in this is the use of the domestic return in setting the hurdle rate for non-domestic investment. We believe that this demand for a risk premium has led to some of the disappointment that investors have voiced over their experience of investing non-domestically.

Since over the longer run, higher inflation adjusted returns are only available through taking on more risk, investors that keep their domestic market return as a hurdle for non-domestic investment are typically pushed up the risk curve non-domestically. This is because, as we will see later, to deliver a return net of fees and taxes means that a higher gross return is required and those higher gross returns mean taking on more risk. In some cases, investors find that they take on risks non-domestically that they would not tolerate in their domestic property portfolio and such risks can potentially unwind poorly.

The prospect of potentially higher returns is an attractive one and one which is likely to overcome the inertia of a domestic-only property portfolio. However, we believe a focus on only the return side of the equation seems destined to deliver potentially unwelcome outcomes. We favor looking at:

- both risk and return
- diversification of the property portfolio
- diversification of the multi-asset portfolio

2. Consider starting with a global portfolio

Investing globally gives rise to the potential for higher risk-adjusted returns within the property portfolio and at the multi-asset level. The theory is straightforward: the non-domestic, global property portfolio dominates a domestic-only property portfolio in terms of return per unit of risk.

If the correlation between the domestic and non-domestic portfolio was 1, there would be little reason to hold the domestic portfolio at all since doing so would lower the return per unit of risk. Given that the correlation between the domestic portfolio and the non-domestic portfolio is not 1 then we believe it makes sense to hold some exposure to the domestic portfolio, creating home bias. How much is sensitive to the assumptions but in general the result is higher than simply the market weight.

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Midtown Manhattan, New York.

3. Entry points and home bias

When investors think about going global there are a range of different entry points that offer a series of trade-offs between risk, return and liquidity. Briefly these entry points fall into:

i) Direct property investment

This is concerned with an investor's direct purchase of assets. The formation of a global portfolio using this route is restricted to all but the very largest investors due to the volume of capital required, assuming that the investor wishes to diversify risk across countries and property sectors.

ii) Indirect property investment

This is concerned with access to properties through, public or private, unitised vehicles. Public vehicles encompass REITs; private vehicles encompass unlisted property funds or funds of funds. Whilst REITs have the benefit of liquidity, they tend to bear a closer relationship with the general stock market than they do to the underlying property market. Unlisted funds, or funds of funds, tend to behave more like the underlying property market with a lower correlation to stocks.

The choice of how to enter the property market will determine the experience that an investor is likely to have and will also determine the extent to which an investor should have non-domestic property exposure, their home bias. There are three key points here:

i) Leverage (and its impact on risk)

Leverage increases risk faster than it increases return and unlisted funds may, to a greater or lesser extent, employ leverage. We believe the level of volatility is important because this is one of the elements that makes the non-domestic, global portfolio theoretically attractive. Once leverage is added, the relative attractiveness of the non-domestic, global portfolio tends to diminish.

ii) Taxation (and its impact on return)

Going global is likely to mean that the returns that are available to domestic investors are not always available to non-domestic investors. Whilst vehicles can be structured to minimize the leakage due to tax, it is not possible to eliminate completely this drag on return. We believe this is important since, as the return on the global portfolio falls, its relative attractiveness falls.

iii) Fees (and their impact on return)

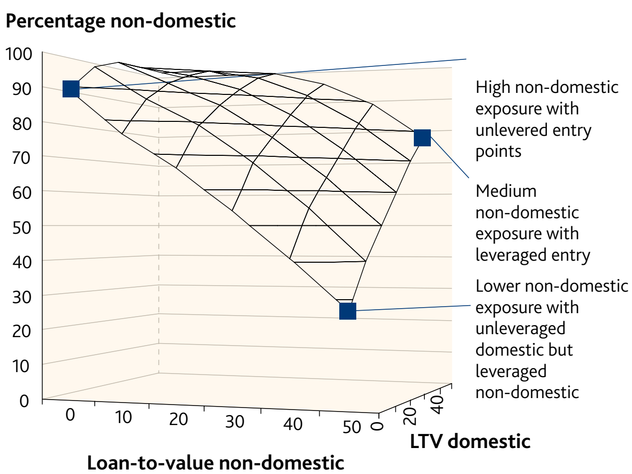
Accessing unlisted funds incurs a fee and this lowers the net return to the investor. Going through a fund of funds will incur another set of fees for fund selection and management. However, offsetting this are the cost savings associated with not having to build an internal property investment team.

The importance of these three factors can be demonstrated relatively easily. If we take the theoretical case shown in Figure 3 and insert some realistic assumptions on the level of leverage, tax and fees we can see that home bias grows considerably.

In the top-left hand corner of Figure 4, there is no leverage in the portfolio but a drag on return of fees and tax. This typically favors the domestic portfolio; however, in countries where domestic fees are relatively high, it may in fact favor the non-domestic portfolio. As soon as leverage is introduced the picture changes markedly. In the bottom-right hand corner, the non-domestic portfolio uses 50% leverage, so doubling its volatility. Whilst there should be some increased return to compensate, the relative attractiveness of this portfolio diminishes. In the far right location, leverage is added to the domestic portfolio, increasing volatility and diminishing the relative attractiveness of the domestic portfolio again.

Figure 4 - Leverage changes the picture markedly

'Optimal' non-domestic allocation depending on Loan-to-value (LTV) - illustrative example only



Source: Aberdeen Asset Management
Note: This example is generic and does not show a picture which is expected to be true for any individual country
For illustrative purposes only.

In our opinion, this relatively straightforward analysis shows that leverage is an important factor when considering how much to invest non-domestically. It demonstrates that there is a trade off between how you enter the property market, both domestically and non-domestically, and how much exposure to the non-domestic property market you may wish to take. For example, for an investor that uses no leverage domestically and wishes to access the global portfolio via 50% leveraged funds, they should have a far lower propensity to invest non-domestically than an investor who chooses to use very low leverage.

This type of conclusion is sensitive to which domestic property market is being considered so, in what follows, we draw some general conclusions for specific countries.

Case studies

1. Canada

The Canadian property market is relatively small in a global context, being around 3% of the global property market.[1] It is tightly held by the larger domestic investors and the strongest assets are infrequently traded. It offers a relatively high level of return per unit of risk and has been highly correlated with the global property market. We believe these factors are important in determining how to approach global property investment from the Canadian perspective.

The high level of return per unit of risk achieved in the domestic market means that, with very little leverage, a global portfolio may become quickly dominated by an allocation to the domestic market. If we assume a very high correlation between the domestic and global property markets (as has been the case in the past) and slowly increase leverage in the global portfolio, it soon becomes apparent that there is little sense investing non-domestically in property from a risk-return standpoint.

However, if we start with some leverage in the domestic portfolio (increasing domestic portfolio risk) and access the domestic market through fund investments (so lowering the net return) the argument becomes more favorable for allocating to global property.

From the table below, we can work through a set of assumptions for both the Canadian and global portfolios. We can then combine these without allowing for tax, fees and leverage that shows an allocation of 12% to Canada. However, once we add in taxes and fees the allocation climbs to 28%. Adding leverage changes the picture even more with an allocation of 51% to Canada assuming 20% leverage in Canada and 33% globally. With lower leverage globally, or higher leverage domestically, a higher non-domestic allocation would result.

Correlation assumed at 0.8	Canada	Global ex-	Combined in theory[A]	Combined in reality[B]	Combined with leverage[C]
Return	6.7	6.6	6.6	5.5	6.5
Risk	10.6	8.9	8.9	9.0	12.6
Return / risk	0.63	0.74	0.74	0.61	0.51
Allocation to Canada			12%	28%	51%

Hypothetical performance used for illustrative purposes only. Hypothetical performance is not representative of any Aberdeen Property portfolio or any actual performance. There is no guarantee that the results obtained with the hypothetical performance will be obtained managing actual assets and returns do not represent actual trading.

2. Australia

The Australian property market is relatively small in a global context, being around 3% of the global property market.[2] The level of return available domestically is relatively high, being linked to a relatively high risk free rate. While there are a number of dominant players in the market, listed and unlisted property vehicles have a long history and the market is relatively frequently traded. The national risk return trade off is around average but the correlation with the global property portfolio has been very high.

From the table below we can work through a set of assumptions for both the Australian and global portfolios. If we combine the Australian and global portfolio, without allowing for tax, fees and leverage, an allocation of 4% to Australia results. This is because the global portfolio is dominant and the correlation is so high that there is little benefit in adding Australia to the global portfolio. However, once we add in taxes and fees the allocation climbs to 28%. Adding leverage changes the picture even more, with an allocation of 52% to Australia assuming 20% leverage in Australia and 31% globally. With lower leverage globally, or higher leverage domestically, a higher non-domestic allocation would result.

Correlation assumed at 0.8	Australia	Global ex-	Combined in theory[A]	Combined in reality[B]	Combined with leverage[D]
Return	7.1	6.6	6.6	5.6	6.6
Risk	11.7	8.9	8.9	9.3	12.4
Return / risk	0.61	0.74	0.74	0.6	0.54
Allocation to Australia			4%	28%	52%

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[1] IPD, 2012
[2] IPD, 2012
[A] Maximum return per unit of risk
[B] Unleveraged exposures but assuming tax and fee leakage
[C] 20% leverage Canada, 33% leverage global X, based upon optimal allocation following a core strategy
[D] 20% leverage Australia, 31% leverage global X, based upon an optimal allocation following a core strategy

3. UK

In our view, The UK is perhaps the most transparent of the global property markets. It is relatively small at 8% but its transparency tends to draw in a disproportionate amount of non-domestic investors. Domestic property vehicles have low fees in a global context and it is possible to find unleveraged funds; this makes it a relatively efficient location to access property. A relatively high return market, it is also relatively volatile but has had a low historic correlation to the global property market making home bias relatively high.

From the table below we can work through a set of assumptions for both the UK and global portfolios. We can then combine these without allowing for tax, fees and leverage that shows an allocation of 20% to the UK. However, once we add in taxes and fees the allocation climbs to 37%. Adding leverage changes the picture even more with an allocation of 63% to the UK assuming 0% leverage in the UK and 31% globally. With lower leverage globally, or higher leverage domestically, a higher non-domestic allocation would result.

Correlation assumed at 0.6	UK	Global ex-	Combined in theory[A]	Combined in reality[B]	Combined with leverage[C]
Return	6.9	6.6	6.7	5.5	6.2
Risk	12.0	8.9	8.8	9.0	11.1
Return / risk	0.56	0.74	0.76	0.62	0.56
Allocation to UK			20%	37%	63%

Hypothetical performance used for illustrative purposes only. Hypothetical performance is not representative of any Aberdeen Property portfolio or any actual performance. There is no guarantee that the results obtained with the hypothetical performance will be obtained managing actual assets and returns do not represent actual trading.

CONCLUSION

Investing globally is a complex issue which should be influenced by more than diversification and the potential for higher market returns. As we have demonstrated, having a clear understanding of the impact of leverage and investment costs, not only on return but also on risk, is important. We also recommend considering any existing property portfolio when expanding an investment strategy in order to ensure that a complete view of the property allocation is taken. As can be seen in the case studies within this paper, this is especially important when considering the entire portfolio's risk profile.

[A] Maximum return per unit of risk
[B] Unleveraged exposures but assuming tax and fee leakage
[C] Unleveraged UK, 31% leverage global X, based upon an optimal allocation following a core strategy

Aberdeen's global property credentials

At Aberdeen, asset management is our primary skill set. Many other asset managers are part of investment banking and life insurance groups; we are not. We are independently owned and managed and have the freedom solely to focus on managing assets for third parties. We believe this allows our investment teams to work at what they do best, across the world, rather than being distracted by a myriad of conflicting business interests and activities.

About Aberdeen's property team

Aberdeen's property team operates a variety of solutions for over 400 clients across the globe with assets under management of $29.7 billion as of December 31, 2012. These solutions are designed for investors ranging from smaller institutions investing domestically in property, to sovereign wealth funds investing globally. Our team has a history of innovation in property fund management from the creation of the first European property fund of funds in 2005 to the design and use of property derivatives.

Our goal as an investment manager is to satisfy clients' property investment needs: segregated or pooled; direct or indirect; public or private; real or synthetic; national or international. We work to develop the right solution for each investor and to provide it on time to the highest international standards of accuracy and professionalism.

Our philosophy reflects our belief that the characteristics of property as an asset class can be exploited to deliver excess risk-adjusted returns in the long term. Our processes are a reflection of this philosophy and are designed to deliver enduring and consistent performance. We do not follow the herd; we identify fundamental value in the markets, since we know that through time our investors will be rewarded for this. Our key objectives are strong investment performance and client service.

Aberdeen's property offices

We have property presence in the following locations: Amsterdam, Copenhagen, Frankfurt, Glasgow, Helsinki, London, Milan, Oslo, Paris, Philadelphia, Singapore, Stockholm and Zurich.

We implement our processes by being:

- a team; within an overall risk budget our people are encouraged to take views and to utilize their skills to the maximum.
- an active property investment manager; unlike most investments, property may offer significant opportunities for a skilled manager to add value after purchase. All assets are regularly appraised to expose these opportunities and the potential balance between risk and return.
- present in key international markets; whilst the global economy becomes increasingly synchronized, we believe local market knowledge and access delivers the opportunities.
- research oriented; just as with other asset classes, excellence in research can help direct our clients' investments towards the strongest and away from the worst.

Active management, proactive deal sourcing, applied research, local presence and a rigorous investment process are the means by which we add value to property investment. We offer a wide range of property investment funds with different investment styles and a choice of geographic and sector allocations.

In addition to funds holding direct property, we have pioneered the development of funds of property funds. A specialist multi-manager team invests in hand-picked third-party funds worldwide for both fund of funds and segregated account clients.

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