Preparing property investors for a new dawn

Navigating environmental targets and post-COVID trends will be vital for real estate investors

Climate targets carry valuation risk

With the world's governments united behind the climate-related Paris Agreement, property investors must consider what's at stake.

The accord, which came into force in November 2016, aims to limit global warming to below 2 degrees Celsius compared with the pre-industrial Celsius compared to pre-industrial levels.

As the UK gets ready to host the COP26 climate conference in November, it's likely that many nations will redouble their efforts to reduce greenhouse gas emissions, which have risen with a 1.5 degrees scenario. This could have a significant impact on the real estate sector with MSCI data suggesting that property assets in the sector have contributed to carbon emissions by 80 per cent by 2004 – far greater than under the 2 degrees goal.

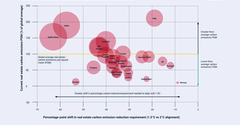
This half a degree has a potentially outsized impact on investors, keeping the temperature rise to 2 degrees would hit valuations by 2.3%, we calculate. But a more stringent scenario needed to limit the rise to 1.5 degrees would hit valuations by 4.0%.

This task will present different challenges in different countries, however, Japan and South Korea have made the most significant strides to make the most significant changes to their climate goals to align with a 1.5 degrees world.

Learn more:
Real Estate's Climate-Transition Risk: The Path to Net-Zero

Three key considerations…

…and how investors need to respond



Plotting the most efficient pathway to net-zero carbon emissions is not an straightforward task. The transition will vary by characteristics of the real estate. Countries vary in the speed they are moving towards zero. Many are working to meet intermediary targets that the national average.

Analyzing a hypothetical portfolio including the proportions of energy and carbon intensities of the underlying properties will be a good first step toward climate risk.

The most energy efficient assets, for example, the most extensive renovations, will need the most investment in intensive assets. Yet, the greatest carbon reduction may be found in the less efficient or first measures.

Learn more:
Translating Climate Goals into Action in Real Estate Portfolios

If investors are serious about getting to net-zero, then they need to know where to start when it comes to enhancing their property assets.

It's important to focus on the parts of the portfolio where you can have the biggest reductions in emissions, and target mitigations in energy use for the lowest cost, while also ensuring that value for any capital expenditure.

The right approach might not always be the one that delivers the most efficiency, improving the energy and emission intensity of a larger building that is deemed 'moderate' risk in terms of its climate credentials could be more beneficial for a portfolio than improving a small high risk building.

Will Bulkeley
Head of Real Estate Solutions Research, MSCI

Foundations shaken by COVID-19

The fear and uncertainty created by the coronavirus pandemic was evident in every part of the financial markets – including real estate.

In February 2020, the listed hotel, industrial, office and retail sectors fell in tandem as lockdowns spread around the world. But as the pandemic progressed, the fortunes of each category diverged.

On a global basis, only the industrial sector produced a positive return between end-January 2020 and April 30 this year, according to the MSCI Monthly Core Net Real Estate Index.

As the recovery progressed and mass vaccinating vaccines provided further hope, hotels and retail began to recover from the worst hit. Yet, the office sector continued to lag given the ability for workers to work from home.

This narrative was mirrored in the private real estate space, but less dramatically.

Only three private office markets recorded a negative total return in 2020:

Office	Office	Office
-1.5%	-1.6%	-1.8%

Learn more:
How Office Real Estate Performed amid COVID

Digging deeper

Analyzing the performance of office assets throughout the coronavirus pandemic is more complex than it might initially seem.

It is common to link underperformance to COVID-19 lockdowns, but many cities in Asia were just particularly badly hit during the height of the COVID-19 crisis as people stayed at home.

However, vacancy rates – or the changes in them – played a significant role.

Office that remained fully leased throughout 2020 outperformed the MSCI Global Annual Property Index by 2.7 percentage points and adjusted the proportion of vacant space performed even better.

Learn more:
COVID-19's Uneven Impact on Office Vacancy

What do investors need to consider?

It's important that investors understand that headline numbers only tell them so much.

Global data, for instance, will mask regional differences in how various property sectors have performed.

And the movement in vacancies also had a small but notable impact on returns, with buildings that filled empty space outperforming those that remained fully leased all year.

How investors across property can also impact vacancy rates. Asian-focused listed real estate companies reached more quickly and more fully to the pandemic's challenges, although less frequent data for private assets means disparities aren't immediately visible.

Will Bulkeley
Head of Real Estate Solutions Research, MSCI

Informed strategies for turbulent times

Tactical decisions

Core real estate investors without the scale to invest directly or through segregated mandates can often decide whether to access the asset class via open-ended or closed-ended funds.

Open-end funds tend to offer investors greater liquidity than closed-end funds, allowing investors to enter and exit the funds at regular intervals. Closed-end funds typically have a fixed life span and are aimed at generating properties in established geographies and property types and use limited leverage.

Closed-end funds, on the other hand, tend to focus on higher return strategies, such as those in emerging markets and those with higher levels of leverage. Closed-end structures give managers latitude to execute such strategies but offer less liquidity to investors.

It's also important to remember that while the aggregate performance of the two types of funds is comparable, this masks significant differences between the results of the open- and closed-ended fund universes.

20% closed-end funds

The 5th-to-95th-percentile spread in **time-weighted returns for closed-end funds from 2015-2020, compared to…**

5% for open-ended funds

However, due to the way in which closed-ended funds deploy their capital, it's crucial to consider different measurements of performance.

3.2%
The annualized time-weighted total return for closed-ended funds between 2015-2020

4%
The annualized time-weighted total return for open-ended funds for the same period

5.25%
The money-weighted returns of the same closed-ended funds for the same period – a rise of almost two bbsis

Learn more:
Open- vs. Closed-End Real Estate Funds: How the Choice Mattered

Unpicking performance

Despite differences in strategy focus, **the aggregate performance of open- and closed-ended real estate funds in the U.S. has been similar** in recent years.

Differences in data availability and consistency as well as in the preferred metrics between open- and closed-end funds mean their performance analysis is often conducted separately, using different data and different asset classes. The similarity in aggregate performance suggests that this should not be the case.

It's also important to remember that while the aggregate performance of the two types of funds is comparable, this masks significant differences between the results of the open- and closed-ended fund universes.

Embracing private real estate in Asia

While some investors have been comfortable investing in private real estate through open-ended, core, open-end funds, the trend is nascent in Asia Pacific.

As of November 2020, Japan's private real estate funds, excluded from this analysis, accounted for an estimated 1 trillion yen (US$9.4 billion) of the total private real estate market in Asia Pacific, with pan-regional, quarterly valued funds representing just 1% of the market.

A lack of expertly calibrated benchmarks may have held the interest in this sector back, but investors can now use the MSCI/AREA Pan-Asia Quarterly Property Fund Index (PFI).

The APFI is a peer-group index designed to provide a competitive set to better performance and benchmark performance, analyze integrated property and fund level data, and evaluate intra-year, in-region market indicators.

Currency hedging considerations

As investors seek greater international exposure, currency risk becomes a more pressing issue.

The reporting currency used by an investor using the MSCI Global Property Fund Index can lead to large discrepancies in returns.

Comparing performance against both local currency and hedged benchmarks can be a useful exercise to fully reflect the value of a hedging strategy.

MSCI research shows that hedging currency movements reduces investment risk, however, hedging does not always improve the total return.

This means investors might need to consider adopting partial currency hedging in their benchmarks, to help appropriately reflect currency risk and better inform allocation decisions.

	Unhedged		Hedged	
	Standard Deviation	Total Return	Standard Deviation	Total Return
Indexes in AUD	5.1%	5.1%	5.7%	4.2%
Indexes in CAD	7.9%	3.9%	5.9%	4.0%
Indexes in CNY	7.7%	2.9%	5.4%	4.0%
Indexes in EUR	7.9%	5.0%	5.7%	3.1%
Indexes in GBP	7.4%	5.1%	5.7%	3.9%
Indexes in JPY	10.6%	2.8%	5.3%	2.6%
Indexes in SEK	7.9%	5.1%	5.7%	3.9%
Indexes in USD	4.3%	3.1%	4.1%	3.9%
Indexes in Local Currency	8.1%	4.2%		

Conclusion:

Tactics
The needs of property tenants are likely to continue to change as the post-pandemic period progresses, and the ability of landlords to use their capital to promote sustainability will only increase.

Monitoring
Monitoring how property assets perform and the uncertain landscape, which may be made even more uncertain by the ongoing central banks's use of the liquidity quantitative easing programs, will be vital for investors to find and keep hold of access the asset class.

Hedging
Real estate remains a key diversifier for local currency diversified portfolios and investors who have a meaningful exposure to the big 4 sector equity markets are more likely to strike the right balance between risk and reward.

For more information, please visit:
www.msci.com/research/real-estate

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