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A test of conviction

Hodes Weill & Associates and Cornell University's Baker Program in Real Estate warn in their annual Institutional Real Estate Allocations Monitor report that there could be a waning of conviction towards the asset class, despite allocations increasing.

By Jonathan Brasse

The second annual Institutional Real Estate Allocations Monitor, jointly published last month by advisory firm Hodes Weill & Associates and Cornell University's Baker Program in Real Estate, suggests real estate is perhaps at a crossroads. The report says that institutional investors, the life blood of the world's private real estate investment market, are continuing to increase their investment allocations to the asset class and continue to be under-allocated to it.

That sounds good, although many of the world's core real estate markets are also reaching cyclical zeniths. Combine that aspect with the prospects of increasing interest rates, slowing economic growth, too much new supply in certain markets and plentiful capital ramping up competition for assets and those institutions still with sizable allocations to address are finding themselves in a potential bind.

That upshot is apparent in the research. More than 60 percent of the 231 institutional investors that participated expressed a decline in their conviction regarding future real estate investments. They were asked on a scale on one to ten to reflect their view of the investment opportunity from a risk-return perspective. Just 19 percent, by comparison, indicated an increase in conviction.

Douglas Weill and David Hodes, co-founders of Hodes Weill, and David Funk, director of the Baker Program in Real Estate at Cornell, explain their findings to PERE. They say that when considering why there is a general eroding of conviction among participating institutions, the strong appreciation of prime assets and, subsequently, the compressing of yields that comes in tandem has a lot to do with it.

Yields achieved for prime offices in cities like London and New York, for example, have in recent months dipped below the 4.5 percent mark. Only last month, a prime office in Tokyo changed hands at a yield of lower than 3 percent. Weill says: "There's general uneasiness that yields are unlikely to go lower and these core assets are fully priced at this point of the cycle. That's the fundamental issue."

The research notes that the average target allocation to real estate stands at 9.38 percent, up 49 basis points from 2013. Institutions want to increase this allocation further in 2015 too, but by a smaller 24 basis points, demonstrative of a comparably more bearish stance on the sector today than last year.

Cornell's Funk comments: "You can look at that as a glass half full or half empty. The conviction index is on the slightly optimistic side but the trend line is down. One way to read that is investors are pulling back a bit in terms of their optimism but still have increased their allocation by 50 bps this year and will do by 24 bps next year. Clearly, there remains a wall of money tactically marshalled."

Agrees Weill: "It's not that they're pessimistic, it's just they are less optimistic."

Music to ears

The research also reveals an approximately 89 basis point under-allocation to private real estate and that is comparably

large when matched with other asset classes. Weill suggests it is best to regard this spread as "more of a long term indicator".

Nonetheless, given that shortfall, if investors are indeed today less convicted about the asset class than before, what then are their options? Hodes Weill and Cornell have found that institutions increasingly are now focusing their efforts on higher-yielding value-added and opportunistic strategies and in less well-trodden marketplaces.

Music to the ears of private equity real estate firms, they found that approximately 66 percent of institutions are actively pursuing these strategies in 2014 compared to 52 percent that are chasing core real estate strategies. Just as sweet for such folk is the finding that 71 percent of institutions expect to invest in private funds in 2014, up from 58 percent in 2013.

Further, while there has been a general reduction in conviction with regards to institutional investors in real estate, sentiment differs from region to region. Participants still prefer US investments, but 44 percent favor European and the UK for new investments. That data point is supported by various property brokerages. Savills, the London-based firm, for instance, predicted last month that investment in the 15 European markets it monitors could exceed €160 billion by year-end. In the same month, Catella, the Stockholm-based financial advisory, reported there was €515 billion of current interest in European real estate, half of which likely would be deployed.

Hodes Weill and Cornell note, however, that though institutions are becoming more adventurous in seeking real estate investments further up the risk curve, the emerging markets –historically harbingers of high risk but, at times, handsome returns, still are receiving little institutional love. Indeed, just 22 percent of respondents are actively investing in emerging markets in 2014 – an increase on the 18 percent that were doing so last year, but still a small percentage.

"There is more differentiation by investors when considering emerging markets," says Hodes, "Although many still want to invest on a regional basis in, say, Latin America, some have gotten over-exposed to Brazil so they are considering sub-regional strategies now. And now many former pan-Asia investors are picking specific countries to target, such as Japan and China.

But he warns the low level of interest in such markets might dissipate further if global economic volatility continues. "If the markets continue to be volatile, then people might pull back in terms of their risk appetite.

Engaging the brakes

And volatile the equity markets have been. PERE spoke with Weill, Hodes and Funk just days after global stock markets plunged on macroeconomic uncertainty deriving from unfolding negative events like the protests in Hong Kong and the spreading Ebola virus, as well as various negative indicators coming from Europe and China. In the month to October 20, the Dow Jones was down 6.35 percent, the FTSE100 down 8.5 percent and the Hang Seng 4.4 percent.

Add that volatility to a REIT universe now trading at cyclical highs, a factor also relevant to premonitions concerning valuations in core real estate markets, and the reasons for engaging the proverbial brakes mount. Pointing out that REITs mainly sit within an institution's equities portfolio, Hodes nonetheless comments: "REITs are somewhat predictive – they set valuations for core real estate in my view. The equities markets have been on fire for the last two years. The respondents in the last survey were cognizant of that and factored it into their allocations."

Whether Hodes Weill and Cornell's findings transpire remains to be seen. Only in its second year, however, already it has gleaned a decent reputation for getting it right. Remarks Hodes: "We were pleased to see that institutions did indeed increase their allocations by 50 bps as predicted in 2013. We expect allocations to notch up by 25 bps next year so we'll see."

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Weill concludes: “My expectation is you’re going to see allocations continue to march forward to being a 10 percent-plus asset class. Within five to 10 years’ time I think there’s opportunity for the overall real assets allocation to be a 15 percent asset class. But that’s just my gut”. Real estate is supposed to be a long-term hold asset class after all.