

The impact of currency on the performance of European non-listed real estate funds

Snapshot **Research**

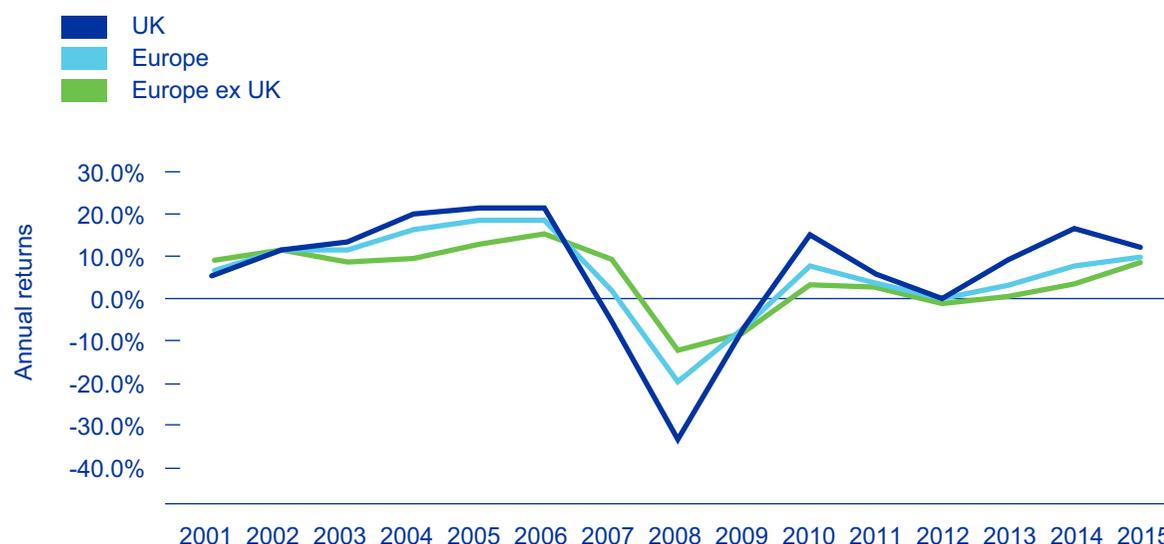
Getting currency right can be the difference between hitting or missing a return target

- > Currency returns can dominate real estate returns
- > Currency forwards are the most popular hedging instrument
- > Getting the hedge ratio right is the most important decision

Currency movements may well be a zero sum game in the very long term, but that does not mean that currency risk can be ignored. Over shorter periods, currency risk is significant. Currency movements on their own can make

the difference between a target being reached or missed. For managers of non-listed real estate funds, currency movements could spell the difference between a client retained and a client lost.

Figure 1: Real estate fund returns 2001 to 2015



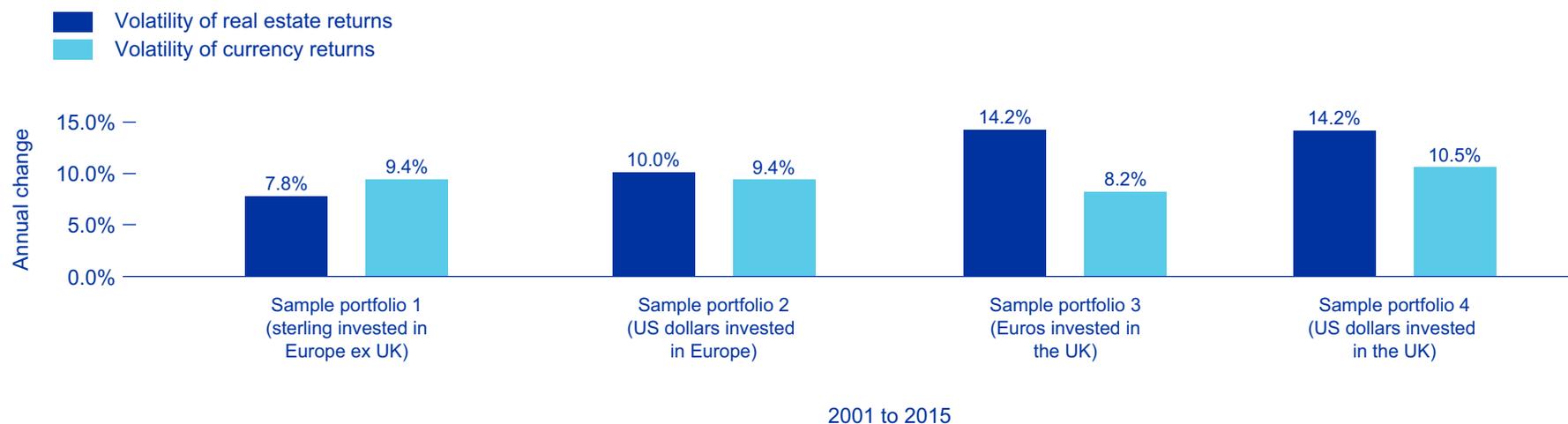
A survey of INREV investor members was held in April 2016, to examine how currency issues are handled. A broad profile of investors responded to the survey, comprising pension funds (38%), insurance companies (33%), sovereign wealth funds (8%), multi-managers (8%), fund of funds (5%), family offices (3%) and other (5%). These investors accounted for a minimum of €154.5 billion in their non-listed real estate portfolios (GAV). This is a minimum figure because 21% of the investors who responded chose not to disclose the value of their non-listed real estate portfolio.

The survey found that 71% of respondents hedged currency risk. The currencies that are most often hedged are US dollar and sterling. Several investors indicated they hedged only against the mature country currencies, but not emerging market currencies.

Continual currency hedging was the preferred strategy - only 24% of investors choose to hedge at specific times. Forwards are the

‘Currency movements could spell the difference between a client retained and a client lost’

Figure 2: Comparison of real estate and currency risk 2001 to 2015



preferred hedging instrument and hedges are typically applied over three months. Hedging ratios were seen to be more important than the choice between different forward hedging terms (such as three months, six months or nine months). For example, choosing between six month forwards and three month forwards is less important than setting an appropriate hedge ratio.

The impact of currency hedging can be assessed by looking backwards into history. The study does so by estimating annual returns in the period 2001 to 2015 with five different hedge ratios (0%, 25%, 50%, 75% and 100%). Risk reduction of between 25% and 36% was observed when hedged portfolios were compared to unhedged portfolios.

There was considerable volatility in individual years such as 2008, when the euro and the Swiss franc strengthened significantly against sterling. Real estate markets also had their share of excitement over the period 2001 to 2015. For example, the UK market lost one-third of its value in 2008. When real estate and currency effects are combined, an unhedged position in UK real estate would have cost investors over 50% of their value in that year.

Forward-looking estimates can also shed light on the effect of currency hedging. Therefore, the study contains the results of a modelling exercise. The exercise is effectively a summary of thousands of random but reasonable guesses. 'All models are wrong, but some are useful', according to the

statistician George Box, and for this study the model is definitely useful. The model forecasts a realistic range of annual real estate returns, currency returns and hedging costs, for four different portfolios. It indicates that the optimal hedging ratio will fall somewhere in the 50% to 100% range and that on average the 'sweet spot' in terms of return to risk ratio is a hedge ratio of 81%.

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