

The case for non-listed real estate in multi asset and in the real estate portfolio is even stronger than before

Executive Summary

Real estate's role in institutional investor portfolios has gained ground over the last two decades. It is now widely accepted that real estate has desirable investment attributes, such as an attractive risk-adjusted performance, diversification potential in a multi-asset portfolio, a high and stable income return, and a degree of inflation protection.

This paper restates those attributes with the latest research and analysis from the non-listed real estate perspective. It also positions the sector within the current investing landscape, examining the portfolio construction possibilities across geographies and sectors, as well as the prospects for non-listed real estate in the face of the latest secular trends such as the growing interest in operational real estate and an increased focus on environmental, social and governance (ESG) issues.

Overall, we expect an increase in both actual and target allocations to real estate, and non-listed real estate vehicles in particular, given their attractive investment features and an ultra-low real bond yield environment. Many institutional investors are below their target real estate allocations. INREV data

show an average allocation to real estate within the overall portfolio of 9.3%, compared to an average target allocation of 10.0%, indicating there is room for institutional capital to continue to flow into the asset class in all regions.

The analysis shows that non-listed real estate exhibits relatively good risk-adjusted performance with low volatility and a solid and stable income return, a good proxy for direct real estate. It also is a better diversifier of equity risk than other alternative asset classes and listed real estate. Most importantly, it appears to offer a great diversification potential to portfolios with high bond holdings.

This report also considers real estate portfolio construction and diversification across several dimensions: size, geography, sector, investment route and investment style. A close examination of the non-listed universe reveals that it offers a wide range of options in terms of both geographies and sectors. The market's growth over the last two decades has resulted in a proliferation of vehicles, which also supports diversification for investors, with the additional advantage that the performance of non-listed is closely related to that of the direct market.

The recent evolution of the non-listed real estate universe is largely driven by core strategies, and this has been enhanced with the growth of European open end diversified core equity (ODCE) funds and non-listed real estate debt funds. Their strong investment attributes are expected to drive further allocations to these vehicles.

In general, the non-listed real estate approach has attained high levels of transparency and governance and has been rapidly embracing environmental and social ambitions. Liquidity has been improving, both through secondary market trading and the evolution of new products and investment structures.

The investable universe is also expanding by geography, sector and investment style. The increasing focus on operational real estate sectors, ESG and impact investing is expected to further enrich the non-listed offer.

'Non-listed real estate seems to be an excellent proxy for the direct market and an excellent diversifier in multi asset portfolios.'

Why Invest in Non-Listed Real Estate Vehicles

The diversification benefits of real estate within a multi-asset portfolio have always been one of the most important reasons to invest in this asset class. To understand the benefits of non-listed real estate as part of a multi-asset portfolio, it is relevant to look at the both the relationship between the three main investing approaches to real estate – direct, non-listed and listed – as well as their performance and correlation versus traditional asset classes such as bonds and equities. We also consider other benefits such as income and real estate as an inflation hedge.

Real Estate Performance

Much of the academic literature examining the performance characteristics of real estate and its role in a mixed-asset portfolio focuses either on direct or/and listed real estate or examines the relationship between the two. However, one study¹ that also includes non-listed real estate uses almost three decades of US market data to determine optimal real estate allocations for various investment horizons within a multi-asset portfolio.

This research concludes that when considering a medium- to long-term horizon, investors should allocate 10% to 20% of their portfolio to direct real estate. However, it also found that open end core funds are a good substitute to gain this direct allocation. This ability to be a proxy for the direct market can be useful when considering the other challenges of investing directly. It is particularly relevant for short-term investors, which could avoid the high transaction costs of direct property investing.

In contrast, listed real estate is considered as poor substitutes for direct investments, even over longer time horizons. Its importance

in the portfolio also decreases significantly if open end core funds are considered alongside direct real estate.

Multi-asset performance

To understand the performance of real estate in a multi asset context, we looked at the absolute and risk-adjusted performance of a number of real estate, traditional and other alternative asset classes, which are broadly representative of institutional portfolios. At the same time, we compared these asset classes' volatility and correlation² (see Figure 1).

Figure 1: Asset classes' performance 2001-2019, ranked by Sharpe ratio - Mean and standard deviation - 19yr 'smoothed'

	Direct RE	Bonds	Hedge Funds	Non-listed RE	Listed RE	Private Equity	Equities
Mean (arithmetic)	7.0%	4.8%	6.5%	5.8%	11.3%	9.4%	5.9%
CAGR	7.0%	4.8%	6.1%	5.5%	8.2%	4.6%	3.8%
Standard deviation	4.1%	3.8%	8.7%	8.0%	24.6%	28.7%	19.7%
Sharpe ratio	1.70	1.26	0.74	0.73	0.46	0.33	0.30

Source: INREV, MSCI, Bloomberg

¹ Delfim, J.-C., & Hoesli, M. E. R. (2019). Real estate in mixed-asset portfolios for various investment horizons. Journal of Portfolio Management, 45, 141-158.

² All returns are based on transaction prices except the returns for private equity real estate, which are based on appraisals. The direct real estate returns are unlevered and do not include overheads. Asset classes are represented by the following indices: bonds – Barclays Capital EU govt. all bonds index; equities – MSCI Europe index; private equity – LPX Europe listed private equity; hedge funds – Eurekahedge European hedge fund index; listed real estate – FTSE EPRA NAREIT developed Europe index; non-listed real estate – INREV annual index; direct real estate – MSCI European property index.

Figure 1 shows that listed real estate at 8.2% delivered the highest absolute performance, based on the compound annual growth rate (CAGR), followed by direct real estate over the period from 2001-2019. While non-listed real estate's performance was lower at 5.5%, it still outperformed bonds, equities and private equity.

It should be noted that listed real estate's performance comes with a higher level of volatility. This is shown by the standard deviation, which puts listed real estate's volatility was second only to private equity. While non-listed real estate's volatility is higher than bonds and direct real estate – which is in line with expectations – it is lower than all other asset classes.

Non-listed also fared well when considering the Sharpe ratio, which measures risk-adjusted returns. Direct real estate and bonds had the best risk-adjusted returns but this was closely followed by non-listed real estate and hedge funds.

Correlation

Another way to demonstrate the benefits of holding non-listed real estate in a multi-asset portfolio is to examine the correlations between the asset classes.

It is notable from the results (Figure 2) that non-listed real estate is very highly correlated to the direct market. This reinforces the argument that non-listed real estate is a good proxy for direct real estate.

Another important finding is that non-listed real estate is an excellent diversifier for bond-heavy portfolios. This is a particularly relevant for institutional investors in non-listed vehicles, such as pension funds and insurance companies, which tend to have high bond holdings to meet their liabilities.

Figure 2: Correlation between annual returns 2001-2019

	Bonds	Equities	Private Equity	Hedge Funds	Listed RE	Non-listed RE	Direct RE
Bonds	1.00						
Equities	-0.24	1.00					
Private Equity	-0.24	0.95	1.00				
Hedge Funds	-0.22	0.74	0.73	1.00			
Listed RE	0.01	0.77	0.82	0.73	1.00		
Non-listed RE	-0.28	0.39	0.44	0.50	0.59	1.00	
Direct RE	-0.35	0.43	0.46	0.46	0.55	0.96	1.00

Source: INREV, MSCI, Bloomberg

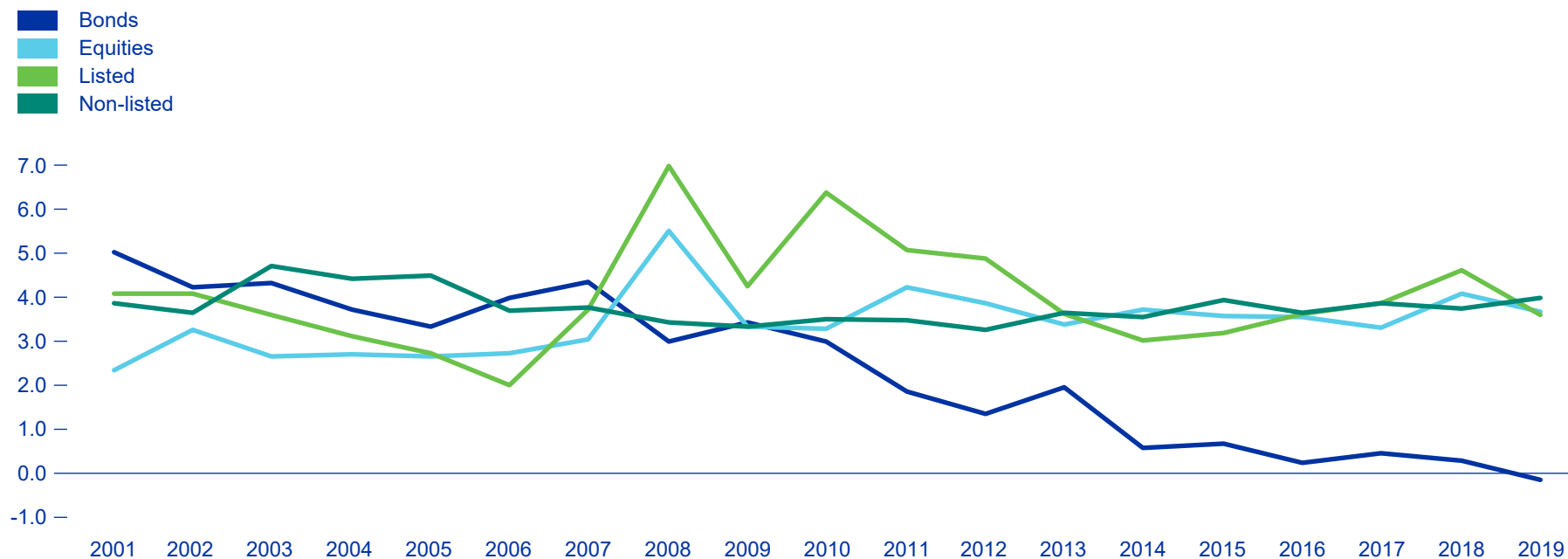
Income return

The attractive income profile of real estate is the second most important reason why institutional investors favour this asset class.³ This and its bond-like characteristics make it particularly attractive at a time when sovereign bonds are very expensive and bond yields extremely low and, in some cases, negative.

Figure 3 shows the income component for different asset classes in Europe. While the stock market still features yields that are comparable to the ones offered by real estate, bond yields have suffered a major decline since the global financial crisis (GFC) and the Eurozone debt crisis.

While the yield gap between non-listed real estate income returns and bond yields was generally insignificant until 2010, it has started to increase as interest rates have been slashed and quantitative easing has been put in motion. With many valid arguments that interest rates, and consequently bond rates, will remain relatively low even when economic growth resumes to normal, the gap between real estate (including non-listed real estate) and bond yields is likely to remain significant.

Figure 3: Yield compression, 2001-2019 (%)



Source: INREV, Bloomberg. Yields for 10yr government bonds, equities (MSCI) and listed RE (FTSE EPRA NAREIT developed Europe) income return for unlisted RE (INREV Asset Level Index)

³ANREV/ INREV/ NCREIF Investment Intentions Survey 2020

The income component for non-listed real estate vehicles has averaged 3.8% over the 2001- 2019 period, according to the INREV Annual Fund Index. This solid performance has been accompanied by a low volatility; income return has represented around 65% of the overall performance (see Figure 4).

Inflation hedge

For many investors, especially pension funds that have liabilities linked to future wage levels, the need to preserve the purchasing power of their assets is a major consideration.

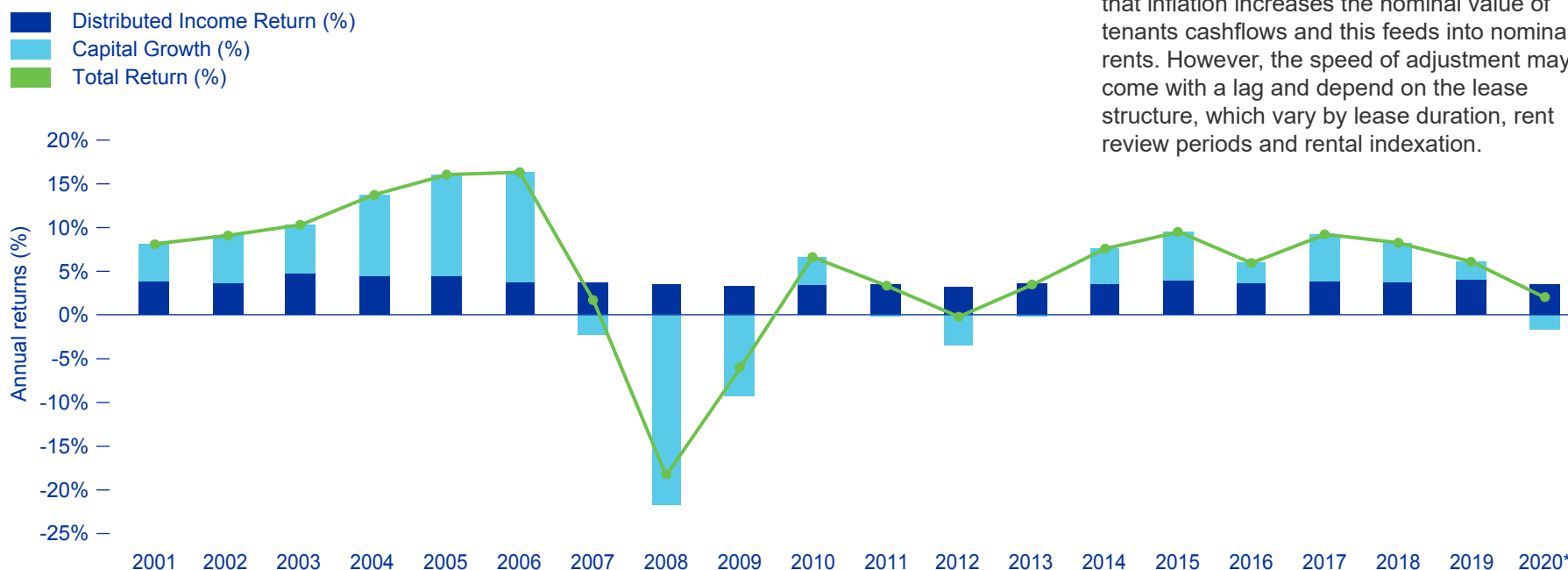
Real estate is often regarded as an inflation hedge, even though it does not meet the strict definition of an asset that moves in line with rising prices and protecting investors from unexpected surges in inflation.

In general, investors in real estate do not seek to directly hedge inflation in the short term but expect their real estate investments to maintain value and outperform inflation over a long horizon. Overall, real estate is inflation sensitive and can provide inflation protection when inflation rises, albeit with a lag.

It is subject, however, to other risk factors such as GDP growth and supply shocks that make the relationship more complex. The bulk of academic studies affirms that in the long-run, real estate performance moves in line with inflation.

Real estate is considered as an inflation hedge on conceptual grounds mainly because of its income growth, which is linked to inflation and because construction costs keep up with price increases. Underlying real estate returns derive from both income and capital appreciation. Rental income is expected to be responsive to inflation, to the extent that inflation increases the nominal value of tenants cashflows and this feeds into nominal rents. However, the speed of adjustment may come with a lag and depend on the lease structure, which vary by lease duration, rent review periods and rental indexation.

Figure 4: INREV Annual Fund Index: return components



Source: INREV Annual Fund Index

Diversification Through Real Estate Portfolio Construction

For institutional investors, the non-listed sector offers access to a wide range of investment styles both on the equity and debt side, which are evolving over time. This allows for diversification within real estate portfolios by defining property strategies both in terms of geography and property sectors but also in terms of investment styles.

The value of the investible real estate market in the EU 28 countries is estimated to be EUR2.7 trillion. Non-listed funds own the biggest share of this at around 30% of total, while EU listed property companies and REITs account for 20%. Insurance companies, pension funds and sovereign wealth funds hold a further 16% invested directly in commercial property, along their non-listed and listed investments.

Non-listed is now the most common form of real estate investing in Europe other than directly owning a building. Investors on average allocate the majority of their real estate assets under management to non-listed funds.

Over the last two decades, the European non-listed equity real estate funds universe has become much more diverse. The INREV Annual Fund Index has grown from 45

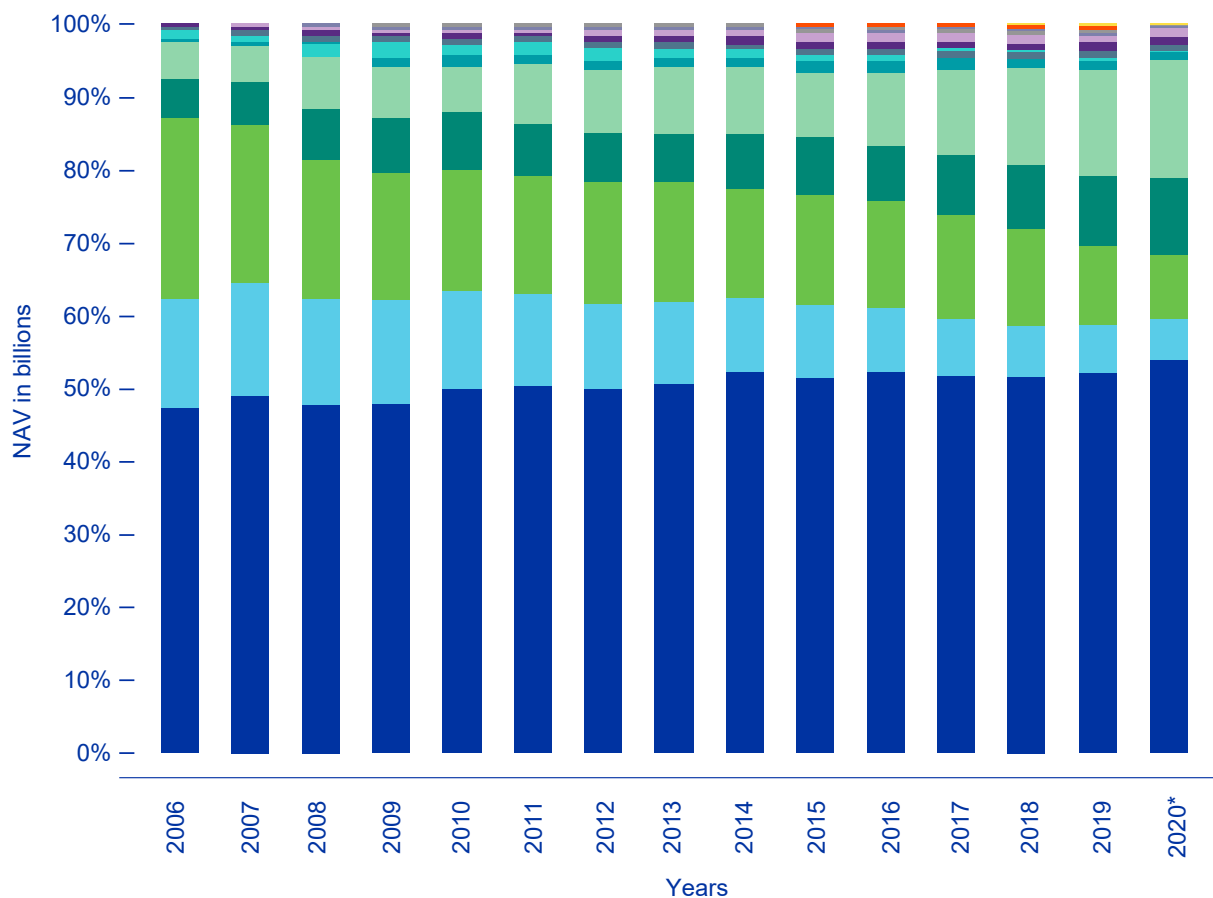
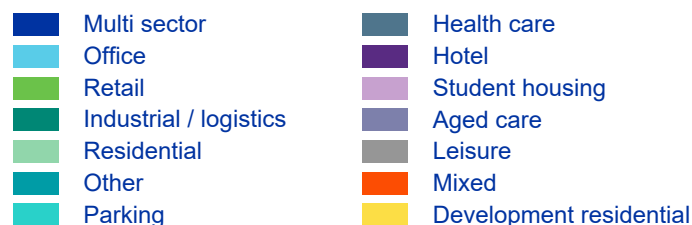
vehicles representing €16.9 billion of net asset value (NAV) in 2001 to 367 vehicles representing €207.3 billion of NAV in 2019.

The last decade also experienced the emergence and rapid growth of non-listed real estate debt funds, spurred by stricter banking regulations for bank lending to real estate, with large institutional investors, such as insurance companies, bridging the real estate financing gap. INREV's Debt Vehicles Universe grew from 49 vehicles with minimum target equity €27.1 billion in 2016 to 78 vehicles with minimum target equity €47.5 billion in 2020.

'The bottom line is that a full diversification strategy is quite complex to implement. Listed and non-listed investments could be regarded as complementary for achieving a target equity property portfolio exposure.'

⁴The December 2019 MSCI Pan-European index reflecting directly held assets of €897.9 billion over 43,530 property investments indicates an average lot size of c.€20.6 million..

Figure 5: INREV Annual Fund Index: return components



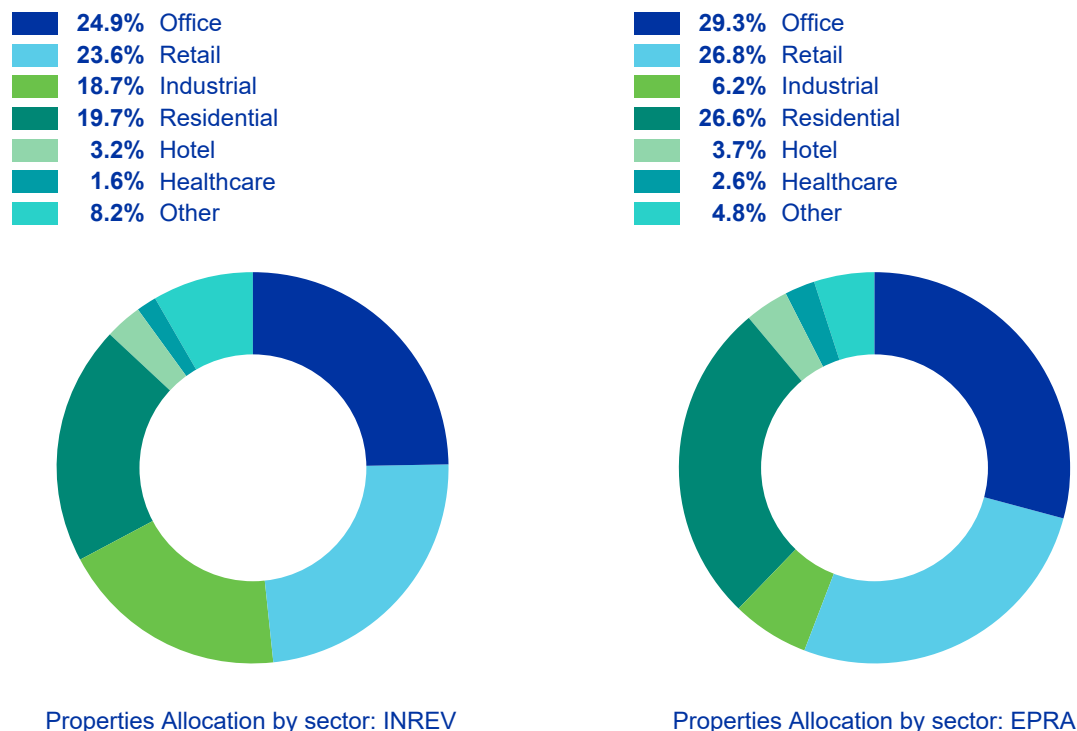
Geographical and sectoral diversification and portfolio construction

Investors often seek to achieve diversification in their real estate portfolios by defining their property strategies in terms of geography and property sectors.

While direct real estate offers the widest universe, accessing institutional quality real estate directly often requires a sizeable capital outlay per asset⁴, as well as a large in-house team. In reality, very few investors can afford to buy a well-diversified portfolio of direct property in each of their preferred sectors. This leaves investors considering indirect routes for portfolio construction through non-listed vehicles and listed property companies.

While the non-listed vehicles have a broad universe in terms of geographies and sectors, those with a multi-country strategy now take a 40% share by net asset value (NAV) of the INREV Annual Fund Index in 2019, with the highest country allocations in the UK, Netherlands and Germany. By sector, multi-sector non-listed funds represent over half of the index. The offer of single sector funds has improved with both more traditional sectors, as industrial and residential, and alternative ones, such as student housing and healthcare/ senior care, gaining traction (Figure 5).

Figure 6: Property portfolio owned by INREV and FTSE EPRA NAREIT Developed Europe constituents, end 2019



*Original categories have been simplified as in "Real estate in the real economy report" so that INREV EPRA portfolio composition is comparable

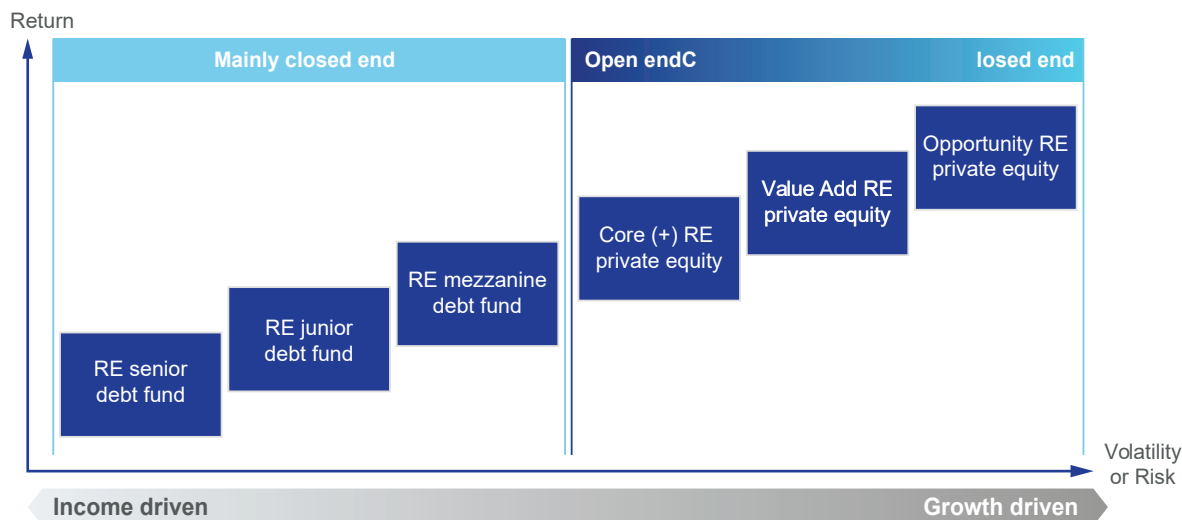
Source: INREV Annual Fund Index, EPRA (data from EPRA Market Research Paper "Sector Report Residential", November 2020)

In general, compared to non-listed vehicles, European listed vehicles tend to be single country focused, and do not have such a wide offer of multi-sector vehicles. However, residential carries a greater weight in the listed universe at 27% compared to 20% for INREV (Figure 6). Non-listed funds are the biggest owners of industrial buildings with 19% share in the non-listed portfolio compared to a 6% portfolio share of listed companies.

The differences in portfolio composition of the listed and non-listed sector within countries add another level of complexity in portfolio construction. Diversification can be achieved by investing in multi-country multi-sector indirect vehicles, which are more heavily represented in the non-listed universe.

‘Portfolio construction comes with constraints, such as the investor’s portfolio and the availability of product to rebalance it in order to achieve the desired geographical and sector diversification.’

Figure 7: Range of non-listed fund types by investment styles



a passive core pan-European exposure, offering immediate access to a diversified portfolio of large stable income producing assets.

The maturity of this sector has been supported by the availability of a robust performance index that allow investors to better monitor and compare performance of their fund investments. The INREV European ODCE Fund Index was launched in 2019 with an inception date of Q3 2011. It includes 14 funds with a NAV of EUR 25.7bn as at the end of 2020 (Figure 8).

Investment style

Investment style is an important driver of product selection. Figure 7 shows a simplified representation of the non-listed real estate investments spectrum on an expected risk-return basis⁵.

Non-listed vehicles can be classified in core, value add and opportunity by investment style. Core equity funds dominate the INREV Vehicles Universe by both number of vehicles and total NAV. They focus on secure income generating assets and tend to be almost

five times larger than the average vehicle with a non-core strategy⁶. They are mostly structured as open end vehicles.

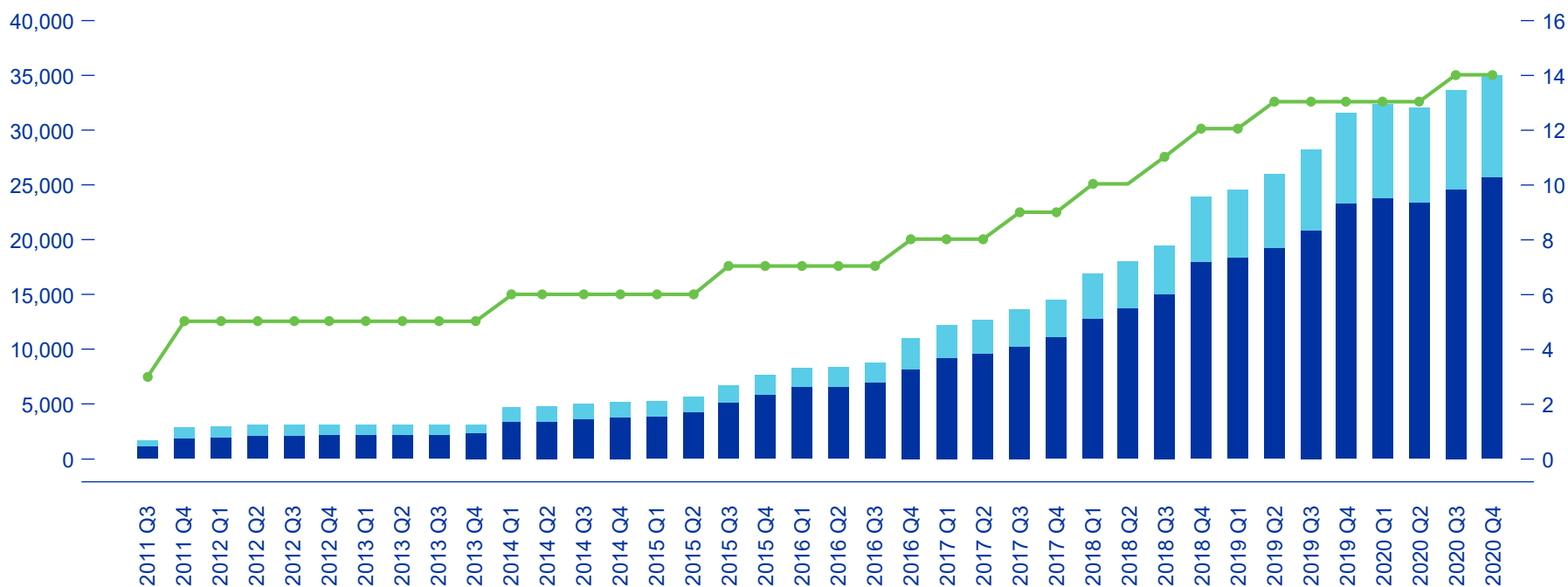
One growing segment of the core market is the open end diversified core equity (ODCE) funds. These are very large in size and invest pan-European and across sectors. ODCE funds offer size and economies of scale in investing and managing their portfolio, low fees, diversification, low risk profile and liquidity. These features make them attractive to small and large investors who are targeting

⁵Overlap exists between the subcategories of debt and equity funds and within equity funds. For example, a core equity fund that offers limited diversification, even though its investment strategy might be low-risk, can be higher risk than a value-add fund that is large and diversified

⁶INREV Q3 2020 Vehicles Universe report

Figure 8: Evolution of European ODCE funds

- Total NAV (€ million)
- Total GAV (€ million)
- Number of Funds - RHS



Source: European ODCE Funds Index

Investment in higher risk strategies is often made to enhance the overall real estate performance of an investor's portfolio. Value add investments deliver returns from a balance of income and capital growth. They follow active investment strategies such as active leasing risk, repositioning/refurbishing and redevelopment/expansion of assets. They carry moderate leverage of around 40% to 60% and development exposure of up to 20% gross asset value.

Opportunistic funds follow higher risk strategies and deliver returns mainly through capital appreciation. For example, they may focus on problem properties with repositioning potential, greenfield developments or emerging markets. They typically have higher leverage and or development exposure to value-add funds. Higher risk funds are often structured as closed end, which does not allow money to be withdrawn during the life of the fund.

Investor and fund manager appetite for real estate debt vehicles has been growing over the last years. With a strong preference for senior debt, non-listed debt vehicles accounted for the largest increase in capital raised for European strategies, jumping from 4.6% in 2019 to 19% in 2020⁷. They generally have a lower risk profile than equity vehicles, although this may not always hold for riskier subordinate debt strategies.

Vehicles with a senior loan strategy make up the largest share of the INREV Debt Vehicles Universe, representing 51% of the number of funds and 62% of target equity, while mixed-debt strategies represent a further 30% of the number of funds and 25% of target equity⁸.

Real estate debt funds have favourable investment attributes for institutional investors such as providing a stable and predictable cash flows in the form of interest and principal payments and downside protection; debt investors enjoy a high degree of protection of their capital value position and very low probabilities of default for senior debt strategies.

'There has been an increase in investment options [...] Product availability up and down the spectrum is a big improvement.'

Real estate specialist, UK based investment consultant

⁷ANREV / INREV / NCREIF Capital Raising Survey 2021

⁸The riskier subordinated junior and mezzanine debt strategies account for less than 20% be it by the number of funds or target equity (INREV Debt Vehicles Universe 2020)

Features of European Real Estate Vehicles

Investing in real estate using non-listed real estate comes with a number of specialist issues such as liquidity, fees and governance. This section examines these topics and demonstrates the improvements that have been made in each area.

Liquidity

Investors in non-listed real estate assess liquidity across two principal dimensions, the required time to enter/exit an investment and the realised trade value of it. A trade-off exists between the two depending on the phase of the economic cycle, with investors being more time sensitive in periods of economic distress and declining values and more price sensitive in normal conditions.

A recent academic report sponsored by INREV⁹ estimated there to be 84 basis points (bps) per annum liquidity over 2010-2016 with an average annual return of 9.6%. The findings suggest that these funds generated an extra 84 bps over listed companies to compensate for the illiquidity of the non-listed real estate market.

The open end fund structure can offer acceptable levels of liquidity to investors under normal market conditions by providing them instant access to a diversified range of

assets and allowing them to redeem capital and exit the fund, if and when needed. However, liquidity may not be available when most desired. Entry timing can be constrained by queues for subscriptions in up markets when there is an abundance of capital and exit timing by queues for redemptions during periods of market distress.

Closed end funds are relatively illiquid, at least from a primary market perspective. They have a limited life, typically seven to ten years, and investors' capital is locked up for the life of the fund. These might also carry an issue of entry liquidity¹⁰; minimum commitment sizes may be prohibitive for smaller investors, for example.

The relative illiquidity of closed end non-listed funds can be managed through the secondary market. A secondary trade is when an existing investor transfers their units to another investor at an agreed price and on specified terms.

Liquidity in the non-listed sector has been improving with trading volumes for continental European funds growing fast in the last five years. In 2020, continental European secondary trade volumes surpassed the UK for the first time and accounted for 58% of the total European market. On the open end side, the growth of European ODCE funds may further enhance liquidity in the sector.

These vehicles are by nature infinite life and relatively large in size.

Separate accounts and joint ventures/club deals offer more liquidity as investors can raise new equity for the vehicles or decrease their exposure. Prerequisite to this is that investors are like-minded with aligned interests. However, the overall liquidity, will depend to a large extent on the liquidity of the underlying assets.

'The illiquidity of non-listed real estate is a function of both the liquidity profile of the underlying assets and the structure of the vehicle itself, as well as the market specific liquidity. While fund units can, in some cases, be easier to buy and sell more quickly than direct property holdings the liquidity of these fund investments varies.'

⁹Understanding real estate illiquidity premiums better 2018

¹⁰INREV (2015) Investors perspective on indirect real estate liquidity

Management fees and expenses

Following the GFC, there has been an increased focus on transparency and fee reduction, motivated by a low yield environment where costs have a higher impact on performance than before. Fund management fees have been declining in recent years across asset classes, driven by increased manager competition and cost transparency for investors¹¹.

Investing in real estate incurs higher costs than other asset classes¹² due to the heterogeneous nature of the underlying assets necessitating considerable due diligence and transaction costs, the need for active asset management and performance related fees.

Non-listed vehicles are typically externally managed and as such management fees in funds are generally based on assets under management. INREV has established the INREV Standard Data Delivery Sheet, which promotes the disclosure of information on a consistent and clear manner. It has also established cost metrics for the standardisation of reporting and comparability among their members, as well as expense ratios.

Transparency, governance and extent of investor control

The non-listed sector has improved transparency around information disclosure, performance and governance as the industry has matured. The leadership role of INREV and its members since 2003, as well as regulatory requirements, have been critical in this journey to maturity.

INREV regularly publishes information on market size and trends, as well as a suite of annual and quarterly fund indices as well as specialist indices including the IRR Index, the European ODCE Index and the German Vehicles Indices. It also publishes the Asset Level Index, which measures pure real estate performance stripped from leverage and financial structuring, demonstrating how much more granular data that is now available.

Following the GFC, regulatory authorities introduced the Alternative Investment Fund Managers Directive (AIFMD), a regulatory framework that applies to almost all EU-registered hedge funds, private equity funds, and real estate investment funds. Overall, AIFMD has had a strong positive impact on the real estate industry with fund managers benefiting from “passporting”, a single

approach to marketing in the EU market, and investors from higher transparency and disclosure of information, comparability and stronger corporate governance.

The legacy of the GFC also affected investor behaviour¹³. It highlighted the weaknesses of fund structures and agreements and the need for greater transparency and reporting. Large institutional investors focused on transforming the structure and terms of funds to secure stronger alignment of interest and governance by ensuring that the parameters of the investment strategy were set appropriately, and fund documentation was detailed and covered unforeseen events. Investors also require low and better use of leverage for risk management and regulatory reasons in the case of insurance companies¹⁴.

Overall, investors are overall looking for greater levels of control and this depends on the structure of the investment vehicle. Separate accounts, joint ventures and club deals offer more control, but scale is needed to achieve diversification, so they tend to suit larger investors. In addition, they will employ closed end funds for investing in alternative sectors, higher risk strategies but also for investing in specific geographies and sectors.

¹¹Bfinance (2019), Investment management fees: is competition working for investors?

¹²Callan (2019) 2019 Investment Management Fee Study, December 2019

¹³The following discussion on investor behaviour is largely based on the publication INREV Coming of age: the rebirth and renewal of the non-listed real estate industry 2019

¹⁴Capital requirements of Solvency II directive

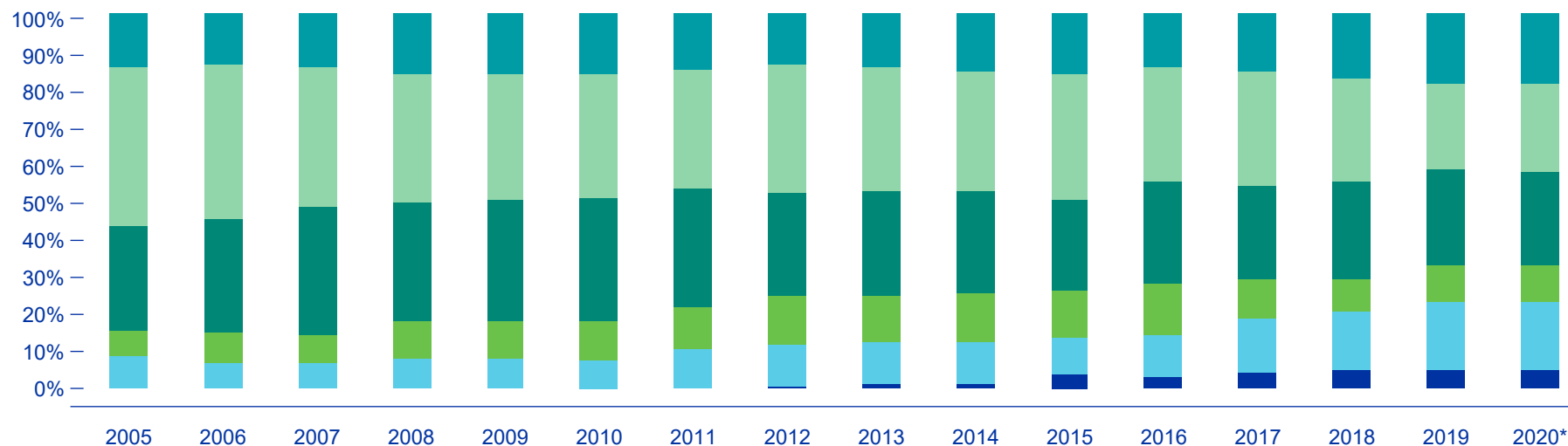
This shift by larger investors for more control has also driven the growth of open end funds, which are usually favoured by smaller and medium-sized investors seeking to invest in passive core investment strategies in non-domestic markets.

The open end structure does not provide control over decision-making. However, it offers access to stabilised assets, high levels of governance and the capacity to liquidate as an alternative type of discretion.

‘Improvements in level of control; improved transparency; quality of engagement between fund managers and investors, with a better recognition by fund managers of investors expectation, fund managers are better educated on alignment of interest with investors; more funds available in the universe.’

Figure 8: Evolution of European ODCE funds

- Mixed-use & development
- Residential
- Other operationally-intense sectors **
- Office
- Retail
- Industrial / Logistics



Source: INREV Annual Fund Index 2021. *preliminary data ** Excluding cash and unreported figures

Secular Trends

The rise of megatrends such as technology and demographics, and the implications of climate change are causing a dramatic impact on the real estate industry. In addition to the challenges these pose, there are opportunities with the investible universe expanding by geography and sector. An increased focus on operational real estate sectors, ESG and impact investing is expected to enrich further the attributes of real estate and the non-listed offer.

Operational real estate

Over the past decade, growth in non-listed allocations in Europe to less traditional real estate sectors such as residential and mixed-use has outstripped that of office, retail and industrial/logistics (Figure 9). Residential subsectors such as co-living, student and senior housing are also gaining traction.

This trend has been accelerated by the Covid-19 pandemic, which will also likely drive further change in non-traditional real estate investments. While it is still early to draw meaningful conclusions, some sectors such as healthcare-related real estate could benefit while some others such as hotels could be negatively affected, at least in the short-term.

Following investors' interest for operational core assets over the last few years, the yield gap between operational real estate and more traditional sectors such as offices and retail has been largely reduced, depending on the market and asset type.

Historically, operational real estate has been a compelling proposition but met with concerns about complexity and potential illiquidity. However, investment turnover in operational real estate has been rising over the last few years as a result of factors such as a strong and stable demand; supply constraints (at least for some sectors such as senior housing and healthcare); stable income returns; and a decorrelation from the macro business cycle.

Investors are also attracted by the long-term lease features of some operational real estate segments such as senior housing and healthcare. For some investors, these offset the higher operational risk related to the business' ability to generate revenues from the asset. The ability to increase income by implementing active asset management represents another desirable attribute.

Finally, while the performance of sectors such as offices and retail depend on the turns of the business cycles, some types of operational real estate are less responsive to cyclical fluctuations in the macroeconomy and more correlated with long-term secular trends.

Traditional sectors are evolving too. For example, traditional offices are being influenced by flexible and/or co-working office leases, where the provision of facilities management and other services is central to performance. The retail and logistics sector are also developing, as a result of social and technological transformation due to the rise of online shopping. Overall, investors are faced

with a core investible universe that is rapidly changing in composition.

ESG and impact investing

The integration of environmental social and governance (ESG) issues into investment decision-making is important for risk reduction and protecting shareholder value. It has been led by a combination of environmentally or socially responsibility but it is also recognised as generating long-term returns based on stable, well-functioning and well-governed social, environmental and economic systems. The reality is that the industry also need to prepare for new regulations and disclosures in this area.

There is growing recognition that efficient buildings can yield higher returns by being more attractive to tenants. This means reducing overall vacancy and supporting higher rental values. It can also limit risks related to depreciation and obsolescence of assets and enhancing risk-adjusted returns. Energy efficient buildings should show higher risk-adjusted returns, although data quality is not robust enough to univocally demonstrate this assumption for different sectors and markets.

Finally, it is understood that assets which perform well on ESG metrics are more liquid. The point is especially important for an asset class as real estate, which is typically less liquid than others such as bonds and equities.

As ESG policies become crucial for investment and asset management decisions, there is an equivalent increasing focus on data quality and availability. Data has been improved with the creation of benchmarks such as the Global Real Estate Sustainability Benchmark (GRESB), which was established in 2009 to measure and benchmark ESG aspects, and has gained wider adoption across the industry. The INREV Sustainability Reporting Guidelines have been aligned with current industry standards, and are widely adopted in the sector.

The conversation has also broadened beyond environmental factors. There is now a focus on the “S” in ESG, connecting the relationship the organisation has with its workforce, its tenants and wider society. Social aspects

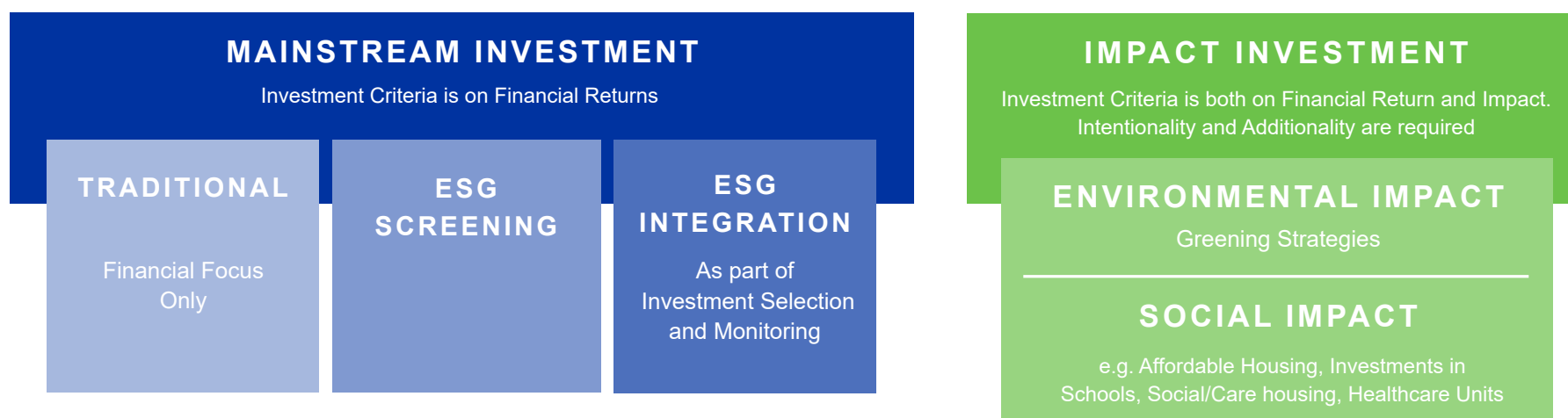
cover a wide-ranging array of matters, including health hazards, diversity, equity and inclusion (DEI) policies and supporting communities. What constitutes success in these area is more subjective and less easy to measure. Nevertheless, the industry is working hard to develop common metrics to measure the impact on social aspects. The development of artificial intelligence and big data will also support the analysis as more data can be collected and analysed to improve the quality of the information provided.

Related to this social angle, is the rise of impact investing. The size of the impact investment market across asset classes now exceeds €600 billion¹⁵. At times, it is difficult to distinguish between ESG and impact

investing. However, impact investing needs to have clear goals relating to social and/ or environmental outcomes, together with the expectation of financial returns. It should have the core characteristics of ‘intentionality’, ‘additionality’ and ‘measurement’, in tandem with financial goals. Examples of social impact investing in real estate include housing, health and education.

To facilitate investors understanding of the different approaches to real estate investing, INREV has developed The Spectrum of Investment, i.e. a framework to map out different investment approaches for real estate, depending on investors’ ambition for environmental and social impact (see Figure 9). These range from traditional investments (far left) to impact investing (far right).

Figure 9: Environmental and social ambitions



Source: INREV Spectrum of Investment 2020

¹⁵GIIN “2020 Annual Impact Investor Survey”

Concluding remarks

The position of real estate in institutional investor portfolios has long been discussed. It is widely accepted that real estate as an asset class has desirable investment attributes, such as attractive risk-adjusted performance, diversification potential in a multi-asset portfolio, a high and stable income return and a degree of inflation protection. This study reexamines the above arguments and demonstrates there is a strong case for both non-listed real estate in multi-asset portfolios and within real estate portfolios, and that the prospects look bright. The analysis shows that non-listed real estate exhibits relatively good risk-adjusted performance with low volatility and a solid and stable income return. It also is a better diversifier of equity risk than other alternative asset classes and listed real estate. Most importantly, it appears to offer a great diversification potential to portfolios with high bond holdings. Many institutional investors, such as pension funds, insurance companies and SWFs are below their target real estate allocations. We would expect an increase in both actual and target allocations to real estate, and non-listed vehicles in particular given their attractive investment features and an ultra low real bond yield environment.

We have considered real estate portfolio construction and diversification across several dimensions: size, geography, sector,

investment route and investment style. Portfolio construction comes with constraints, such as investors' existing portfolio and the availability of product to rebalance it to achieve the target portfolio across these dimensions. The growth of both listed and non-listed real estate markets over the last two decades has resulted in a proliferation of vehicles. Diversification for medium- and small-sized investors can be more easily achieved via the indirect market. Specifically, non-listed vehicles present the additional advantage that their performance is closely related to that of the direct market, as our findings indicate. A close examination of the non-listed universe reveals that it offers a wide range of options in terms of both geographies and sectors. If an investor is willing to invest in specific geographies and sectors, this is largely possible by acquiring exposure to non-listed vehicles. Different real estate investment routes, though, could also be treated as complementary for achieving a target allocation to the extent they offer some different pockets of exposure.

Non-listed real estate features a range of investment styles. The recent evolution of the non-listed real estate universe is largely driven by core strategies, such as the growing European ODCE and non-listed real estate debt segments. Their strong investment attributes are expected to drive further allocations to these vehicles. There are several reasons that make the case for

non-listed real estate even more compelling than before. The non-listed industry has attained high levels of transparency and governance and has been rapidly embracing environmental and social ambitions. Liquidity has been improving, both through secondary market trading and the evolution of new products and investment structures. The investable universe is expanding its coverage in terms of geographies, sectors and investment styles. The increasing focus on operational real estate sectors, ESG and impact investments could further enrich the non-listed offer. Higher expected capital flows into the sector in conjunction with increased product options indicate exciting times ahead for investors and fund managers in non-listed real estate.