LIVING THOUGHTS

A BNP PARIBAS REIM RESEARCH PAPER

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THE CASE FOR REAL ESTATE

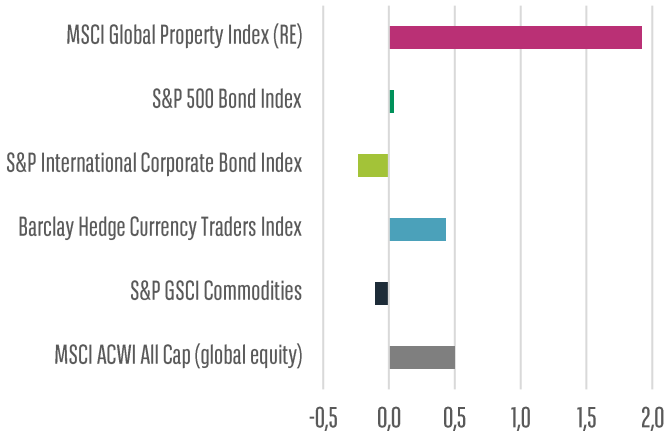
Investors are becoming selective again, to the detriment of the real estate allocations. With the rise in interest rates and falling property valuations, investors are recognising the charm of alternative investments. On the other hand, they are experiencing uncertainty about real estate investments. Disruptions upon disruptions can sow doubts, but the economic case for real estate investment remains justified. In terms of efficient investment, diversification, thematic investments in megatrends, shaping cities and contributing to the reduction of carbon emissions as well as adding value to an asset, these Living Thoughts show why property investments are a valuable alternative in investors' portfolios right now.

TANGIBLE, EFFICIENT AND INFLATION-PROTECTING

Real estate is an integral part of our urban and rural living environments and often creates the character of a place. Real estate is one of the few tangible asset classes and offers investors the opportunity to make a significant ecological and social impact. But above all, real estate offers investors the opportunity to diversify their overall portfolio while simultaneously increasing the efficiency of their investment. Available data for global indices on different classes show real estate is the asset class with the best risk/return ratio, expressed as the so-called Sharpe ratio. This is based on an average annual performance of 7.8% over the last 10 years and a volatility of 3.0%. The MSCI ACWI All Cap (global equity) Index has the highest annual performance (9.5%), but comes with a volatility of 14.7%, leading to a Sharpe ratio of 0.5.

In addition, numerous analyses show that real estate is an inflation hedge. As we also analysed in the February 2022 Living Thoughts, real estate real returns, if generated in markets with rental indexation, together with fixed income, require a significantly shorter minimum holding period than equities (five years vs eleven years) to outperform inflation. In general, the element of continuous cash flow through rental income is one of the strongest advantages of real estate investments.

Real estate is the most efficient asset class - Sharpe ratio* in comparison between 2013 and 2022



Sources: Federal Reserve Bank of St. Louis, MSCI, S&P Global, Barclay Hedge, SS&C; *Reference rate: Average yield of 10-year US Treasury Securities (2013-2022)

DIVERSIFICATION IN THE PORTFOLIO COMES WITH REAL ESTATE

Real estate is an integral part of a market portfolio: it accounts for 12% of global private markets AuM (McKinsey), 14% of assets in investment funds of eurozone pension funds (ECB) and covers 12% of fund assets of German investment funds (Bundesbank). As a whole, real estate offers a clear decoupling from the rest of the investment spectrum. In particular on the long-term perspective, the correlation with the performance of other asset classes is insignificant, which can help investors to improve their risk/return profile.

INVESTMENT MANAGEMENT

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Real Estate for a changing world

Within the real estate world, there are further strong differentiating features due to the various types of use. The healthcare and residential property types, for example, have structural rather than cyclical demand. This means that the return/risk profile can be adjusted even further by targeting specific themes. This is supported by the fact that digitalisation (i.e. transparency, construction, refurbishment) and the withdrawal of the state are now professionalising certain real estate segments that were previously considered uninvestable. The spectrum is therefore broadening. The different geographies of Europe also offer additional differentiation in terms of risk/return profile, based on the local social and economic structures and the maturity of the corresponding real estate market.

Real estate - no significant correlation to other asset classes

<-- long term

	MSCI ACWI All Cap (global equity)	S&P GSCI Commodities	Barclay Hedge Currency Traders Index	S&P International Corporate Bond Index	S&P 500 Bond Index	MSCI Global Annual Property Index (RE)
MSCI ACWI All Cap (global equity)	-	0.2	-0.9	0.8	0.7	0.2
S&P GSCI Commodities	0.1	-	-0.1	-0.2	-0.3	0.1
Barclay Hedge Currency Traders Index	-0.9	0.0	-	-0.8	-0.6	-0.4
S&P International Corporate Bond Index	0.8	-0.5	-0.7	-	0.9	-0.2
S&P 500 Bond Index	0.9	-0.4	-0.8	1.0	-	0.0
MSCI Global Annual Property Index (RE)	0.3	0.6	-0.6	-0.2	0.0	-

<-- long term

mid-term -->

mid-term -->

Source: Federal Reserve Bank of St. Louis, MSCI, S&P Global, Barclay Hedge, SS&C; long-term: 10 years, mid-term: 5 years

SHAPING MEGATRENDS AND CITIES

Due to their omnipresence, properties are carriers of general, long-term trends (e.g. digitalisation, and demographic, climate, and societal change). At the same time, however, they can also be a catalyst for change. Thanks to an enormous outward impact on the surrounding area and population as well as inwardly on the various tenant groups, it is up to property owners to make use of these fundamental trends, generate a positive impact and help shape cities. The EU Commission's ESG requirements in response to these megatrends are a major challenge, but also a strong stimulus for the real estate industry: ESG measures are helping to revolutionise the way the industry works (construction and refurbishment methods, readjustments, forming new collaborations) and to rapidly and significantly reduce the real estate industry's significant carbon footprint.

RECOGNISING RISKS - EXPLOITING POTENTIAL

The main risks associated with real estate investments are the risk of loss of rent, the ability to re-let space, the construction or conversion of a property and property risks during operation. The nature of the risks to be taken should correspond to the risk profile of an investor and is ultimately reflected in the expected return.

In addition to location classification, property investments can cover various risk classes along the life cycle of the asset due to their segmentation by type of use and their nature as a construction. The core/core+ risk classes can currently be found in Europe in the 4%-6% yield range, value add between 7% and 12% and the third category, opportunistic, is currently over 13%. This also explains another special feature: through active asset management, developing micro-locations and markets as well as changing space requirements, real estate investments can realise considerable potential with the right management and market-oriented monitoring of these points. Investments after a market correction also have the potential to outperform.

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