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**Ric Lewis** asks if it is rational for cross-border real estate investors to demand an 'international risk premium'. The UK institutional lease is counterproductive in modern conditions, argues **Paul Taylor**. The Merchant Navy Pensions Administration has plans for third party management, reports **Hugh Wheelan**. **Pol Tansens** examines what Belgium's SICAFI have to offer investors

# At what price fear?

**Ric Lewis**

Increasingly, institutional investors are redesigning their property portfolios to include the potential benefits of international diversification.

Most have been led to this conclusion by new-found recognition of the growing disparity between the global diversification of their equity and fixed income portfolios and the relative "xenophobia" of their property portfolio. For some, this disparity is accentuated by their acceptance of the notion that the world's capital markets are truly global – inextricably linked and increasingly interdependent.

Another group believes in international opportunities but for a very different reason: the opportunity to secure higher returns by making opportunistic investments in capital-starved or capital-inefficient property markets around the globe. While many in this group still grapple with how statistically to "prove" the historical and mathematical benefits of international diversification in their property portfolios, they have witnessed the paradigm shifts that have accompanied the re-organisation of a number of world markets and believe that they can profit from the resulting disruption. Why then are most institutional property portfolios so dominated by domestic investments?

Whether they are believers in diversification benefits or "excess return" possibilities, many fund managers remain appropriately wary of the

lessons learned from past missteps in the international property markets. Perhaps because of their magnitude, these past sins have been memorialised in institutional history and attributed to the notions (now deemed flawed) that foreign property markets would behave similarly to domestic markets, and that a prudent investor could manage international risks from home as easily as it could domestic risks.

To rationalise new international property investment to their colleagues in light of this institutional memory, many real estate fund managers have built into their return expectations a specific premium for assuming property-related investment risk outside of their domestic market – a tolling charge they refer to as the "international risk premium". This premium is an arbitrary incremental additional return requirement assigned to all investment strategies focused outside of the investor's domestic market.

For example, a recent informal survey of international fund managers contemplating an increase in foreign real estate investment activity showed that, on average, fund managers assigned a risk premium of almost 600 basis points to their international investments. The responses, which range from a low of 200bps to a high of 1,000bps premium over a similarly styled domestic strategy, depended on the manager's proximity to and past investment experience in a particular country or region. Furthermore, most admitted that the currency risk associ-

ated with the strategy was significant, but did not represent the majority of the international risk premium they computed. Few could argue with the caution underlying these sentiments. The rationale for such an exercise, however, is flawed.

Finance theory taught us that an appropriate performance measure for any asset class could be built by assuming the lowest risk investment rate in the market area and augmenting it with a series of premiums to reflect the risks inherent in that specific investment strategy. This would lead us to believe that the appropriate return expectation for an international real estate strategy would consist of the sovereign debt rate for the country in question, plus premiums for:

- property asset class risk (representing the systematic risk of the asset class);
- illiquidity risk (to compensate for the difficulty of "monetising" the investment);
- deal-specific or idiosyncratic risk (to compensate for the risk of the structure of the investment or of the specific property)

The finance class calculation does not include an additional premium for lack of information when crossing borders or fear of foreign lands. Since the consumer of the capital does not distinguish between domestic and foreign capital, the foreign capital cannot be paid a premium above the available domestic risk capital. The 'international risk premium' calculation is troublesome in that it seems a rather arbitrary attempt to price the investor's fear of failure in this pursuit. It overlooks the simple fact that an investor can not secure arbitrary premiums for subjective rather than market-based factors.

It is perfectly reasonable that a prudent investor might discount its ability to execute a well-conceived investment strategy away from home. It is equally reasonable that an investor may want to augment required returns to compensate for the opportunity cost of foregoing domestic opportunities or for the organisational time and effort it takes to design and execute a remotely located international property strategy. The assignment of this premium cannot, however, be more focused on the investor's lack of confidence about its ability to execute and manage an international strategy than on the actual risk of investing in the local market. To have competitively priced capital, the international investor must either overcome the "fear-based" risk premium by gaining local market expertise or must seek out opportunities where locally based risk capital is not available.

In the absence of local market expertise, these investors are quite often forced into one of two scenarios. In the first, they find themselves in more aggressive and highly structured transactions where local investors are typically few and returns (and deal-specific risks) are greater. In the second scenario, they struggle in their attempt to source local transactions before they are widely marketed to cheaper local capital. Success under the second scenario requires scouring the local marketplace, property owners and financial intermediaries at least as well as savvy local investors, an exercise which quite often proves impossible for a remotely based foreign investor.

Many of us recognise that globalisation has become a fact of life, with technology and the internet allowing both the rapid, widespread dissemination of information and much greater access to that information. With each passing day it becomes easier and faster for risk capital to cross boundaries seeking investment opportunities. Still, real estate investment remains, in most of the world, one of the most local of businesses. With most transactions privately negotiated amid considerable secrecy, local information endures a significant competitive advantage in making successful property investments.

Prudent strategies for deploying investment capital to gain the benefits of foreign property return performance must be constructed to manage all of the associated risk factors. Managing these risks, however, does not include assigning an arbitrary "international risk premium" to compensate for fear, past indiscretions and execution uncertainty. This renders one's capital uncompetitive and diverts appropriate focus from strategy construction and execution. An improved response would be to focus fund manager scrutiny on the design of these international property investment strategies to ensure that they are conceived with a macro point of view, are aligned with local market knowledge and capabilities, and are executed by staff or partners with experience in creating, managing and harvesting investments in the local environment – whether this be across the street, across a border, or across the world. As investors adopt this approach and increase the certainty of receiving what they bargained for, the arbitrary international risk premium will inevitably decrease to nearer its long-term appropriate resting place – at zero.

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