



# Barclays Wealth Insights

Volume 10: Prospects for Real Estate: On Solid Foundations?

In co-operation with the Economist Intelligence Unit

# About Barclays Wealth

Barclays Wealth is a leading global wealth manager, and the U.K.'s largest, with total client assets of \$221 billion (£134 billion), as of June 30, 2009. With offices in 25 countries, Barclays Wealth serves affluent, high net worth and intermediary clients worldwide, providing international and private banking, investment management, fiduciary services, and brokerage.

Barclays Group is a major global financial services provider engaged in retail and commercial banking, credit cards, investment banking, wealth management and investment management services with an extensive international presence in Europe, the Americas, Africa and Asia.

With over 300 years of history and expertise in banking, Barclays operates in over 50 countries and employs over 145,000 people. Barclays moves, lends, invests and protects money for over 49 million customers and clients worldwide.

For further information about Barclays Wealth in the Americas, please visit [www.barclayswealthamericas.com](http://www.barclayswealthamericas.com) or [www.twitter.com/barclayswealth](http://www.twitter.com/barclayswealth).

## About this report

Written by the Economist Intelligence Unit and commissioned by Barclays Wealth, this tenth volume of *Barclays Wealth Insights* looks at investor perceptions of the global real estate market.

It is based on two main strands of research. First, the Economist Intelligence Unit conducted a survey of more than 2,000 high net worth individuals, with investable assets ranging from \$800k to in excess of \$48m (£500,000 to in excess of £30m)<sup>1</sup>. Respondents are based around the globe, with the highest numbers of respondents in the United States, Hong Kong, India, Singapore, Canada, Spain, Switzerland, the United Arab Emirates, the United Kingdom and Monaco. The survey took place between August and September 2009.

Second, the Economist Intelligence Unit conducted a series of interviews with economists, senior executives and real estate experts from around the world. Our thanks are due to the interviewees for their time and insight.

1. All currency conversions are based on exchange rates as of September 30, 2009, and in some instances are rounded up or down.

# Foreword

Our focus at Barclays Wealth is entirely on our clients and on the ways in which we can help them to protect, manage, enjoy and pass on their wealth. From the outset, we have invested in thought-provoking research which we hope will give both us and our clients a better understanding of wealth globally.

Working in partnership with the Economist Intelligence Unit (EIU), we have developed the tenth volume of *Barclays Wealth Insights*, a series of research reports which aim to provide a definitive picture of what being wealthy means in the 21st century.

As well as consulting with more than 2,000 wealthy individuals globally, the EIU has worked with a panel of international experts drawn from academia, industry and finance, to provide additional insights and perspectives.

In this report, *Prospects for Real Estate: On Solid Foundations?*, we examine the global outlook for residential and commercial real estate markets through the eyes of high net worth investors.

As well as providing a compelling overview of the real estate investment landscape, the report also gives an indication of how investors' attitudes towards the asset class have evolved since the start of the downturn.

Despite the turmoil, the findings suggest that investors are ready to increase their exposure to residential and commercial real estate. Their reasons for and means of doing so are particularly interesting and demonstrate the emotional attachment that many investors have to real estate when compared to other forms of investment.

I hope you find this report an informative and entertaining read.



**Thomas L. Kalaris**  
Chief Executive  
Barclays Wealth

# Our Insights Panel

**Ahmed Al Hatti**, Chairman of Cayan Investment and Development

**Liam Bailey**, Head of Residential Research at Knight Frank

**Yolande Barnes**, Director of Research at Savills

**Sean Brew**, Head of Portfolio Asset Management at DTZ

**Mark Carpenter**, Director of the Property Division at Henderson New Star

**Basil Demeroutis**, Partner at Capricorn Investment Group

**Willie Gething**, Executive Chairman of Lennox Investment Management

**Rory Gilbert**, Head of U.K. High Net Worth, U.K. and Ireland Private Bank at Barclays Wealth

**Philip Jeffcock**, Director, Real Estate at Barclays Wealth

**Issam Kabbani**, Chief Executive of Landmark SA, an affiliate of Synergy Asset Management

**Audrey Klein**, Managing Principal at Park Hill Estate, a subsidiary of Blackstone

**Angus McIntosh**, Partner and Head of Research at King Sturge

**Ian McBryde**, Director of Property Funds at F&C REIT Asset Management

**Mark Meiklejon**, Investment Director at Standard Life Investments

**Laurent Nouvion**, Head of the Rey/Nouvion Family Office in Monaco

**David Salusbury**, Chairman of the National Landlords Association

We would also like to thank the following individuals for their input:

**Charles Beer**, Senior Partner in Real Estate Tax at KPMG

**Paul Bradley**, Spokesperson for the Spanish Property Owners Guild

**Sam Chandan**, President and Chief Economist of the Faculty of Real Estate at The Wharton School of the University of Pennsylvania

**Santosh Rungta**, President of the Confederation of Real Estate Developers Associations of India

**Greg Davies**, Head of Behavioral Finance at Barclays Wealth

**Michael Dicks**, Chief Economist at Barclays Wealth

**Wayne Vandenburg**, Chairman and CEO of TVO Groupe

# Introduction

Although the financial crisis that has led to a severe global economic downturn had many causes, real estate, in the shape of sub-prime loans in the U.S., can be regarded as a key catalyst. At the turn of this century, real estate attracted billions of dollars of investment as homeowners and investors around the world sought to capitalize on an intoxicating asset price boom and on the availability of cheap credit. But for many, there was a hard landing to come, and a reminder that, although real estate has been a source of huge new wealth around the world, it has also proved to be many investors' undoing.

There is a temptation to regard real estate as a “straightforward” investment. Unlike other asset classes, it is universal. At some point in our lives, the vast majority of us invest in bricks and mortar when we buy our own homes, so it can seem like a short leap to invest in real estate purely for financial gain. But while direct real estate investment may not have the financial complexity of some other financial products, it is by no means simple.

As evidence of a gradual economic recovery mounts, investors are once again eyeing real estate markets after many have fallen precipitously from earlier highs. While few will have the confidence to call the bottom with certainty, a growing number of investors consider that the descent has been deep enough to start preparing

for the eventual upturn and are making selective investments. Indeed, in recent months, some real estate markets have bounced back strongly and are appreciating in value.

This report, the tenth in the *Barclays Wealth Insights* series, examines the outlook for the global residential and commercial real estate markets through the eyes of high net worth individuals. Based on a major survey and a series of interviews with high-level real estate experts, the report also looks at the advantages and disadvantages of real estate investment and explores how investors manage real estate as part of a broader investment portfolio.

# Executive summary

**Wealthy investors expect to increase their asset allocation to real estate.** Over the next two years, 35 percent of respondents plan to increase the proportion of real estate in their portfolios (not including their primary residence), while 48 percent plan to maintain their current allocations. The main reason that investors give for the increase is that they believe real estate offers better long-term prospects than other asset classes. Investors from the Gulf Cooperation Council (GCC) states and Canada are most likely to increase their allocations — by an average of 4 percentage points — while Spanish investors are the only respondents who expect their average allocation to real estate to fall.

**Some investors may already have extremely high exposure to real estate.** Almost six out of ten investors from Spain, and just under 30 percent of those from the U.K. and India, say that 50 percent or more of their portfolios are in real estate. Allocation also tends to increase with wealth: Among those respondents with \$48m (£30m) or more in assets, almost 40 percent say that they have allocated more than half their portfolio to real estate.

**Investors can see opportunities in the real estate market, but the scarcity of credit is constraining their options.** Following a prolonged downturn in real estate markets around the world, high net worth investors are once again eyeing opportunities in the sector. Three out of four wealthy investors say that residential real estate is looking attractive, but 60 percent of them say that tight credit conditions are preventing them from taking the plunge. Respondents are slightly less sanguine about opportunities in commercial real estate, with 68 percent saying that they are keen to explore opportunities, but 73 percent of them feel hampered by the high cost of borrowing.

**There is growing confidence about the medium-term outlook for real estate, but prices may have further to fall in the near future.** Although they recognize that current market conditions are throwing up significant investment opportunities, high net worth investors give a cautious assessment of the prospects for their own real estate portfolio. Just under half expect an increase in the overall value of their real estate investments over the next two years, while 29 percent expect no change and 23 percent expect a decrease. Investors from India, Canada and Singapore are most bullish about the future, while those from Spain are least optimistic. More broadly, there are doubts about the incipient recovery in real estate prices. Across the ten focus markets, fewer than half of respondents believe that prices have reached their lowest point in their own markets.

**Outside their own countries of residence, most investors consider the U.S. to be the most attractive real estate market.** The U.S. tops the list by some margin, while the U.K. is tied for second. In both markets, there have been precipitous price declines, so investors may be reasoning that there are bargains to be had. However, there is also considerable interest in emerging investment destinations, such as China and India, which are second and fourth on the list respectively. The appeal of these countries is likely due to a belief that rapid economic growth and rising wealth will fuel demand for real estate and lead to capital gains and attractive yields over the long term.

**Investors may be somewhat emotional in their approach to managing real estate investments compared with other asset classes.** An emotional attachment to bricks and mortar — often stemming from the central role that homes play in people’s lives, but also due to factors like prestige and location — can mean that high net worth investors are often unwilling to sell real estate at short notice and, therefore, they may be less rigorous in measuring its performance as an asset class. Investors also may not be taking advantage of the diversification possibilities within real estate as an asset class. For example, just 29 percent hold indirect real estate investments, such as mutual funds and real estate investment trusts, when these can offer a relatively liquid way to gain exposure to real estate across a wide range of sub-sectors and markets.

**A significantly greater proportion of women than men are keen on investing in real estate.** When it comes to real estate, the survey reveals a striking variation in the attitudes of the two sexes. Nearly half the women surveyed say real estate is a less risky investment than stocks, whereas only 37 percent of men agree with that view. Similarly, while 44 percent of women find buying real estate more enjoyable than investing in other asset classes, just 28 percent of men feel the same way. Women also tend to favor investing directly in bricks and mortar more than men. While 34 percent of men are likely to invest in real estate indirectly through a fund, only 14 percent of women would prefer to go down that route.



# Section One: Trying times for real estate investors

Real estate is a significant source and store of wealth for high net worth individuals around the world, a major destination for their capital and, in many cases, a source of huge pleasure and enjoyment. It is a long-term investment that offers the potential for income, capital gains and a hedge against inflation.<sup>2</sup>

But for investors in most areas of global real estate, the past few years have been a searing experience. In the U.S., the S&P/Case-Shiller Home Price Index, which is a composite of single-family home price indices for the nine U.S. Census divisions, fell by 32 percent from its high in the second quarter of 2006 to the first quarter of 2009. More recently, however, it has shown some signs of stabilizing, rising slightly in the second quarter of 2009 for the first time in three years. The Federal Housing Finance Agency's monthly House Price Index, which is calculated using home sales price information from mortgages that have been sold to or guaranteed by Fannie Mae or Freddie Mac, showed that in August, prices were 0.3 percent lower than in the month before and 3.6 percent lower than a year before. As of August, prices were 10.7 percent below the April 2007 peak.

In the U.K., the Nationwide House Price Index fell from 367 in the fourth quarter of 2007 to 298.7 in the first quarter of 2009, a drop of 19 percent. Again, there was stabilization in the second quarter of the year. That

stabilization is also seen in the August House Price Index put out by the Department for Communities and Local Government. It found that prices rose by 0.5 percent from July to August; however, August prices were still down 5.6 percent from the year before.

Following the trend in the U.S. and Europe, the real estate market in Dubai, which had enjoyed a spectacular boom over the past three years, has also suffered. According to Colliers International, a global affiliation of independently owned real estate services firms, there was a year-on-year decline of 48 percent between the second quarter of 2008 and the second quarter of 2009.

Other regions of the world have fared somewhat better. During 2009, house prices have been booming in China, for example, thanks largely to a massive government stimulus package. According to the National Bureau of Statistics, house prices rose by two percent from July to August 2009 in the nation's biggest cities, double the increase from June to July.

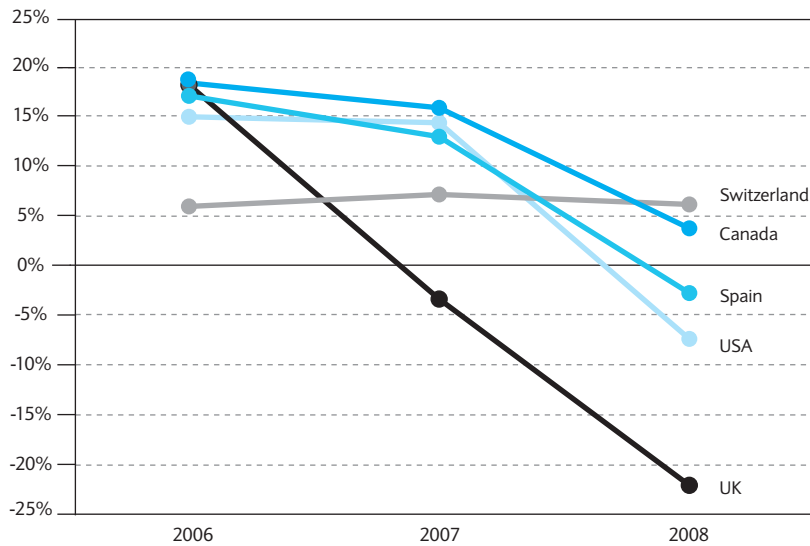
2. Real estate is subject to various risks including, fluctuation in underlying property values, expenses and income and environmental liabilities.

There are concerns, however, that the massive liquidity that has been injected into the market could cause an asset price bubble to form, as loose monetary conditions help support unsustainable increases in the Western world.

If prices are starting to stabilize in some residential markets, the picture for commercial real estate is more mixed. With unemployment continuing to rise in many markets, albeit at a slower pace, demand for commercial real estate in general is likely to remain muted and lag behind a broader economic recovery.

The IPD (Investment Property Databank) Global Property Index, which measures the combined performance of commercial real estate markets in 23 countries, fell significantly in U.S. dollar terms during 2008, showing returns of -10.1 percent compared with 16 percent in 2007. The U.K. fared particularly badly, showing a return of -22.1 percent in 2008. However, demand for well-let, prime real estate is starting to recover in some places, with the IPD U.K. Monthly Property Index rising by 0.2 percent in August, the first time it has been positive in 26 months.

**Chart 1 – Total return on all real estate types between 2006-2008**



Source: IPD national indexes (data for respective countries), September 2009

The picture for the real estate investment trust (REIT) market is also mixed. Since the second quarter of 2009, the FTSE NAREIT Equity REIT index, which tracks U.S. REITs, has shown strong returns, after falling heavily following the collapse of Lehman Brothers. The index dropped by more than two-thirds between mid-September 2008 and early March 2009, but rose by 30 percent in the second quarter and more than 40 percent in the third quarter. The pick-up in performance has been fueled by a broader recovery in equity markets and a wave of equity issuances, as the industry recapitalizes itself, often to take advantage of distressed assets in the real estate market. However, the index is still about 25 percent lower than it was a year ago and there are many challenges ahead for the market, including weak balance sheets and looming debt maturities.

### Preference for real estate persists

Although the outlook for the property market as a whole remains highly uncertain, high net worth investors will continue to see the asset class as an important part of their portfolio. Among the more than 2,000 high net worth investors surveyed for this report, the average proportion of their portfolio allocated to real estate is 28 percent, not including their main residence. Of course, there is no one “right” allocation to real estate for all investors. An investor’s own ideal position will depend on a host of factors, including his or her investment horizon, risk appetite, location, age and personal preferences. Real estate experts questioned for this report expressed a range of opinions about allocation. Basil Demeroutis, a Partner at Capricorn Investment Group (a multi-family

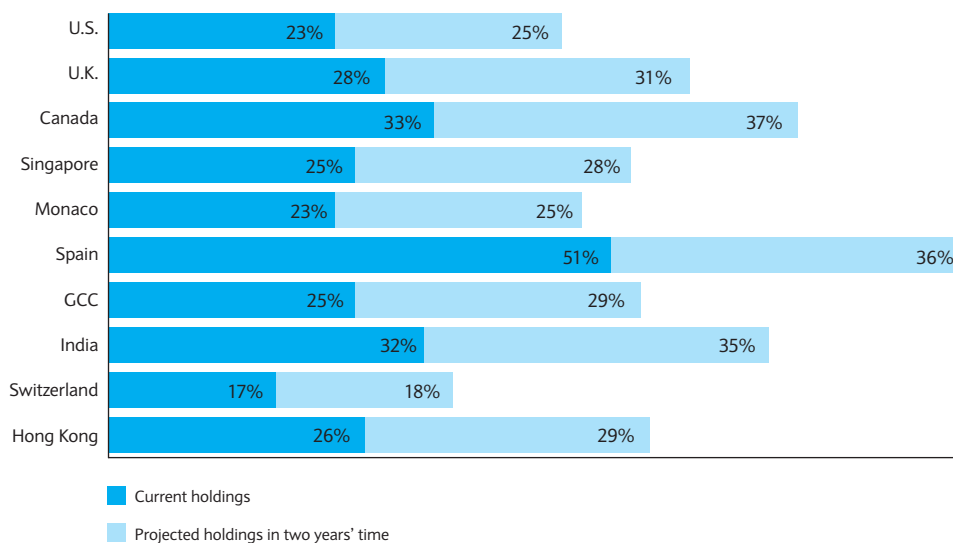
office started by the co-founder of eBay), suggests an optimum figure of between six percent and eight percent, while Laurent Nouvion, who runs the Nouvion family office in Monaco and has a strong preference for real estate assets, holds up to 50 percent.

“There is no doubt that a certain amount of real estate can provide return enhancement and diversification benefits in most investors’ portfolios,” says Philip Jeffcock, Director, Real Estate at Barclays Wealth. “The proportion of wealth allocated to real estate should be reasonable given investors’ liquidity requirements, and their ability to deal with the possibility that they might have to sell an asset with poor liquidity when things go bad.”

The average allocation to real estate of 28 percent among the survey respondents conceals considerable variation in allocations across regions. Spanish investors, for example, have the highest levels of real estate holdings out of the ten focus markets for the survey. On average, they allocate 51 percent of their portfolio to real estate, while 59 percent have allocations to real estate of 50 percent or more. Spain has long had a strong cultural affinity with real estate ownership and the government offers generous tax relief on mortgage payments. It has also been a mecca for foreign investors and speculators, especially during the housing boom of 1995 to 2007, which saw prices rise by 300 percent.

**What is the current approximate allocation to real estate in your overall investment portfolio (not including the primary real estate in which you live)?**

**Chart 2 – Average real estate holdings as a percentage of overall investment portfolio, by country**



Source: Economist Intelligence Unit Survey, September 2009

Investors from Switzerland have the lowest average allocation to real estate, at 17 percent, and only 14 percent have allocations of 50 percent or greater. Those from the U.S. and Monaco also have relatively low allocations at 23 percent. In the case of Switzerland and Monaco, which are both long-established real estate markets, there is some evidence that more experienced investors stayed out of the market as prices soared. “Although we have been investing in real estate for some 50 years, we stopped investing in 2006 and 2007,” confirms Mr. Nouvion. “Prices were simply far too high. They had lost all sense of reality.”

The survey suggests that, in general, allocation to real estate increases with wealth. For example, investors with assets of greater than \$48m (£30m) have an average allocation to real estate of 37 percent, compared with 36 percent for those with wealth between \$16m and \$48m (£10m and £30m), 31 percent for those with wealth between \$2m and \$16m (£1m and £10m), and 23 percent for those with assets between \$800k and \$2m (£500k and £1m).

## Contrarian view creates world of opportunities

CNL Financial Group, a privately held real estate investment company based in Orlando, Florida, has formed or acquired companies with more than \$23 billion in assets and has successfully used a “contrarian” investment approach for more than 35 years. Launched in 1973 by founder and CEO James M. Seneff Jr., CNL aims to identify opportunities in undervalued real estate markets and protect against looming threats in markets that are performing well.

CNL was aggressive in buying discounted hotel properties when the travel market suffered a sharp downturn from the events of September 11, 2001. Conversely, CNL’s contrarian view served the company’s investors well in 2006 and 2007, when CNL foresaw risks in the markets and sold over \$15 billion of real estate assets.

Now CNL views the world and opportunities for real estate investors very differently.

“There is a lot of pessimism right now, but we believe there are tremendous global opportunities in real estate, particularly because of complexities in adjusting markets,” says Mr. Seneff. “We believe the best investment opportunities currently reside in the

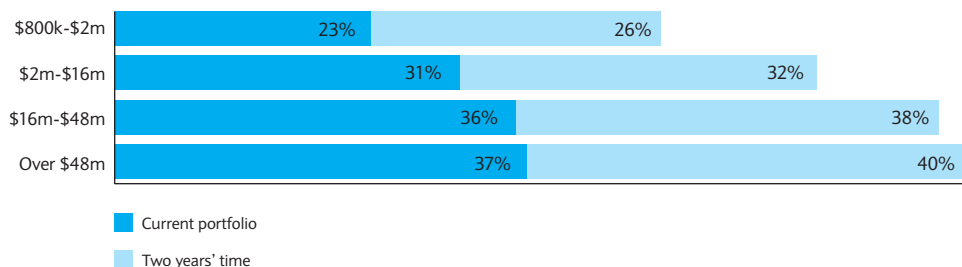
United States, but we also see opportunities emerging elsewhere.”

For example, according to Mr. Seneff, in China there will continue to be a significant population shift from rural to urban areas. So CNL has created a partnership with Macquarie Group to find attractive investing opportunities. The new Real Estate Investment Trust (REIT), CNL Macquarie Global Growth Trust, is focused on growth-oriented assets around the world. CNL’s acquisition strategy will target assets which are well located and designed, and have fundamental growth characteristics, but have fallen out of favor or been impacted due to the credit crunch.

One issue facing many wealthy investors is the decision over how to best allocate the real estate portion of their portfolio. “As an individual has more assets, there is a shift towards broader asset allocation to include real estate,” says Mr. Seneff. However, directly investing in commercial or residential real estate exposes an investor to single real estate risk and requires maintenance of the asset whereas investing in a REIT or REITS can provide a diversified real estate allocation.

**What is the current approximate allocation to real estate in your overall investment portfolio (not including the primary real estate in which you live)?**

**Chart 3 – Weighted average allocation, by wealth band**



Source: Economist Intelligence Unit Survey, September 2009

It is important that investors hold a range of asset classes, not just real estate, in order to have a diversified portfolio. Diversification is important for two reasons.<sup>3</sup> First, it is difficult to predict which asset class will be the best performer each year, so investors should hedge their bets. Second, some asset classes' returns are more closely correlated than others — meaning their returns tend to go up and down in tandem — so it is vital that investors have asset classes with differing characteristics that will outperform in different market conditions. Diversification helps raise returns for a given level of risk.

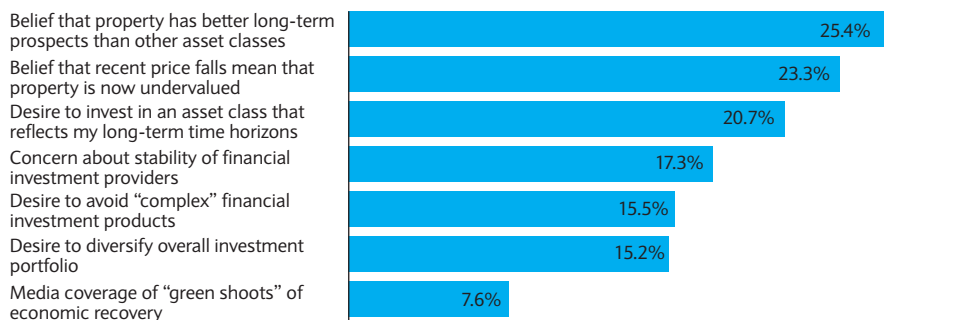
Real estate has generally been considered to have a low correlation with both equities and bonds, although correlations do fluctuate slightly over the course of an economic cycle. However, in the financial crisis of 2008 and the subsequent economic downturn, correlations spiked and many asset classes experienced substantial losses. So while diversification can help lower risk over the long term, there is still the potential for many asset classes to suffer at the same time during short-term crises.

## Upping the ante?

With some major global real estate markets stabilizing after significant declines in value, investors are considering whether now may be the right time to increase their allocation. In general, high net worth investors questioned for this survey plan a slight increase to their overall allocation to real estate over the next two years. On average, allocation will increase from 28 percent to 30 percent. For those who plan to increase their allocation, the main reason cited is that they believe that real estate offers better long-term prospects than other asset classes. This suggests continuing uncertainty about the trajectory of financial assets and a desire for more tangible, “straightforward” investments after the turmoil of the financial crisis, which many people perceive to have been caused by complex financial instruments.

**Which of the following factors have been most influential in determining your increased allocation to real estate?**

**Chart 4 – Key reasons for increasing allocation to real estate, all respondents**



Source: Economist Intelligence Unit Survey, September 2009

3. Diversification does not guarantee against loss.

It is also clear that investors perceive opportunities for bargains amidst the fall-out from the crisis. The belief that recent price declines mean that real estate is now undervalued is the second most important reason given for increasing allocation to real estate. Nonetheless, experts say that investors have, in general, become

much more discerning. “At the height of the bubble, many buyers lost sense of basic considerations: location, quality of building, reasonable financing and so on. However, today investors are much more discerning; the real estate has to be exactly right,” says Yolande Barnes, Director of Research at Savills.

### Barclays Wealth Case Study

## The long-term winning asset

Woodbury Corporation, a 90-year-old family-owned real estate business, focuses on real estate development and management in the western United States. They deem themselves “investor” rather than “merchant” developers. Based in Utah, they began by buying and renovating homes and reselling them. Today, Woodbury controls over ten million square feet of retail, office, and hotel real estate space in a U.S. real estate portfolio worth more than \$1.2 billion.

President Rick Woodbury sees global real estate as a market with secular growth trends, “Real estate is a great long-term investment. Over the short and medium terms real estate values may fluctuate; however, because land is finite, as the world population increases, supply and demand mandates that the value of well-conceived and located projects will increase over the long term, even greater than the rate of inflation. The question is how and when you play and how much staying power you have.”

“In valuing real estate, we are not fancy. We focus on the basics of location, layout, construction quality, and replacement cost as well as true cash flow,” says

Woodbury. “We ensure stability by limiting our debt leverage and diversifying in enough properties and tenants so that no two or three properties have a significant negative impact if the unexpected happens.”

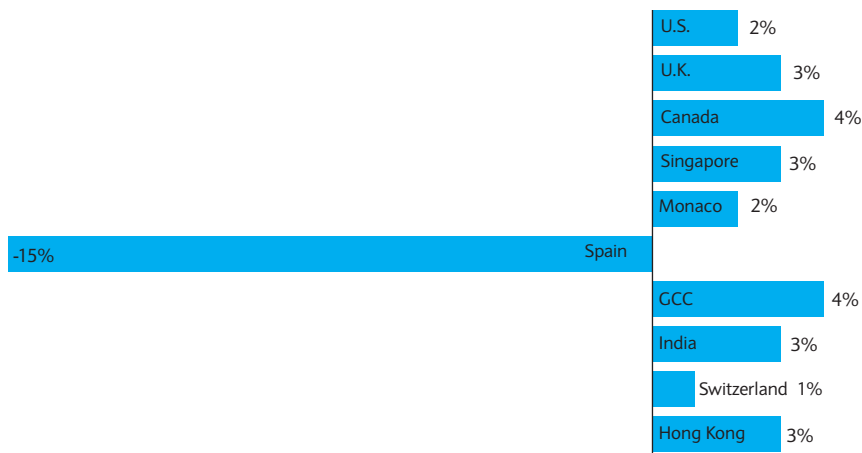
Woodbury believes that real estate in the U.S. is near the bottom, creating ample opportunity for investors. “Over the last decade some have invested recklessly because of easy money and a misperception that real estate had little risk,” says Woodbury. “Commercial real estate became overvalued, but adjustments have taken place and are continuing to take place. We are excited about the current opportunities,” Woodbury continues.

To capitalize on the current market opportunity on a larger scale the company is partnering with like-minded investment partners, such as the family offices of John R. Miller and Jonathan W. Bullen.<sup>4</sup> By combining efforts, Woodbury is able to deploy more capital across more assets enhancing the already attractive risk return relationship.

4. For a quarter of a century, the Salt Lake City, Utah-based family offices have managed the wealth of the Bullen and Miller families. They initially gained real estate investment experience in the late 1980s. Partnering with a third-party operator, the family offices capitalized on the U.S. Savings & Loan crisis and subsequent government Resolution Trust Corp. bailout in the 1990's by acquiring multifamily apartments and commercial real estate at depressed prices. The value strategy yielded a portfolio that is currently comprised of more than 9,000 apartment units and over two million square feet of office space located across the western United States.

What do you expect to be the average percentage change in your real estate portfolio over the next two years?

Chart 5 – Expected average change (%) in real estate portfolio over next two years, by country



Source: Economist Intelligence Unit Survey, September 2009

Breaking the survey results down by region, there is a remarkable consistency of opinion, with investors from nine out of the ten markets expecting to increase their allocation by between 1 percent and 4 percent. The major exception to this trend is Spain, where the average allocation for investors will fall by 15 percent, according to the survey. More dramatically, perhaps, 13 percent of Spanish investors intend to reduce their holdings of real estate to zero, bringing the total with no exposure to the real estate market from 15 percent to 28 percent. This striking finding suggests a continuing lack of confidence in the Spanish real estate market, even after significant price declines. Asesores Financieros Internacionales (AFI) forecasts that Spanish real estate prices will fall by 30 percent from peak to trough and that the market will not turn positive until at least 2011.

“There are over one million unsold new properties in Spain which will need to be cleared out prior to any recovery.”

A key reason for this gloomy forecast is a glut of supply. “There are over one million unsold new properties in Spain which will need to be cleared out prior to any recovery,” says Paul Bradley, a spokesperson for the Spanish Property Owners Guild. “That will take at least another three to four years. So the ideal time to return is just prior to these unsold properties being cleared out, when new development begins again.”

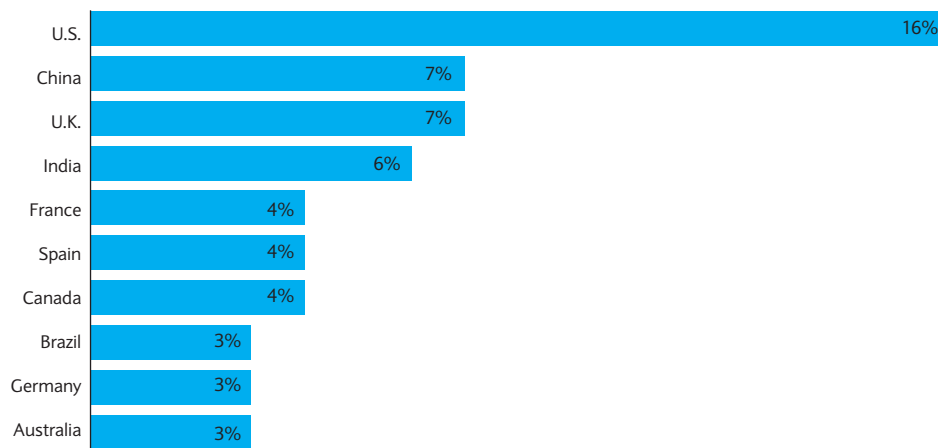
### Investing with a home bias

Just over three-quarters of the investors questioned for the survey invest primarily in their domestic market. But asked about the overseas country where they saw the greatest potential for returns, two interesting themes emerged. The first of these is that the market regarded as the most promising, by some margin, is the U.S. There is clearly a view that recent price declines, a weaker currency and the long-term prospects for the U.S. economy offer significant opportunities. Similar reasons are likely to influence the selection of the U.K. as tied for the second most promising market.

Liam Bailey, Head of Residential Research at Knight Frank, a real estate agent, notes that the prime real estate in London has begun to see strong buying interest. “We have seen an increase in registered interest for prime and super-prime real estate, which is usually an indication of coming price increases,” he says.

In which country, other than the one in which you are personally based, do you expect return on investment (ROI) to perform most strongly over the next two years?

Chart 6 – Top ten countries (other than respondents’ own) where highest ROI is anticipated



Source: Economist Intelligence Unit Survey, September 2009

Some interviewees caution, however, that there may be more turbulence to come in the U.S. market. “Housing markets in the U.S. currently enjoy the support of direct policy intervention,” says Sam Chandan, President and Chief Economist of the Faculty of Real Estate at The Wharton School, University of Pennsylvania. “As these interventions taper off, the dynamics of the housing market could be upset.”

The second interesting theme is related to the growing appeal of emerging markets as real estate investment destinations, with China and India second and fourth respectively on the priority list. Compared with the U.K. and U.S., these are non-traditional real estate markets for the wealthy, but investors are clearly attracted by the solid economic growth currently being seen in both countries and the emergence of a huge middle class that, for the first time, will have disposable income to purchase real estate.

Santosh Rungta, President of the Confederation of Real Estate Developers Associations of India, suggests that the Indian market is one that shows promise.

“Demand for residential real estate is slowly growing, particularly in the affordable category,” he notes. “Projects have realigned their prices and this has led to strong demand.”

Concerns persist in these markets, however. For example, a huge injection of lending by the Chinese government has fueled real estate speculation and prompted concerns that the current rise in real estate values will be unsustainable over the longer term. In India, there continues to be a highly fragmented and inconsistent legislative environment; however in September 2009, the government announced proposals for a new regulatory authority to oversee the real estate industry.

## Managing uncertainty in the U.S.

Although the U.S. was chosen by more survey respondents than any other country as the market (other than their own) where the ROI will be the greatest over the next two years, some experts are less convinced that real estate prices are stabilizing.

**“Many companies are looking at net leaseback, where they sell their real estate to an investor and then lease it back from them.”**

Wayne Vandenburg, Chairman and CEO of TVO Groupe, an international real estate investment and management services company, believes that the bottom of the market has not been reached in the U.S., and ongoing uncertainty is making some potential investors reluctant to jump back in.

Many major institutional investors have already written down significant losses. For example, Mr. Vandenburg says that Calpers, the California Public Employees' Retirement System which manages approximately \$190 billion in assets, has reportedly re-priced its real estate portfolio down to approximately \$11.2 billion from \$17.9 billion to reflect changes in current capital values.

Other investors who are leveraged are simply handing the keys back to the lender. Mr. Vandenburg describes a major developer who recently let go of

several large office buildings in a California city because the equity in the real estate was gone (due to falling prices) and the income the buildings were generating was insufficient to service the loans. Mr. Vandenburg says this was the right business decision and highlights what the U.S. is facing.

However, not all real estate investors are cutting their losses just yet, even when their preferential financing deals come to an end. “Say you owe \$50 million on a property and the outstanding loan matures, but the bank now can only underwrite a \$42 million loan, or \$8 million less,” Mr. Vandenburg says. “You can write a check for that \$8 million, but in these troubled times how many people have that amount of liquidity in addition to the other issues facing most investors? So the banks do something the industry commonly refers to as ‘pretend and extend,’ which means they extend the loan at the old real estate value for a short period of time such as one year. But of course, they hike up the rate to make it worth their while.”

Other investors are taking advantage of opportunities presented by cash-strapped corporations due to the upheaval in the credit markets. Mr. Vandenburg says that many companies are looking at net leaseback transactions, where they sell their real estate to an investor and then lease it back from him. This gives the company a source of financing — which it may need to fund the company in these credit-crunched times — and provides the investor with real estate that has a guaranteed tenant and yield.

“This sector is just gearing up,” says Mr. Vandenburg. “Net lease transactions are at 10 percent of what they will be in the next 24 months.”

## Opportunities abound but credit is still crunched

With investors expecting to increase their allocation to real estate over the next two years, it follows logically that they perceive opportunities in the current environment. In general, this seems to be the case, but there is a significant difference between the perception of opportunities in residential and commercial markets. In addition, the availability of credit makes a big difference in the ability of investors

to take advantage of available opportunities — even for those at the wealthier end of the spectrum.

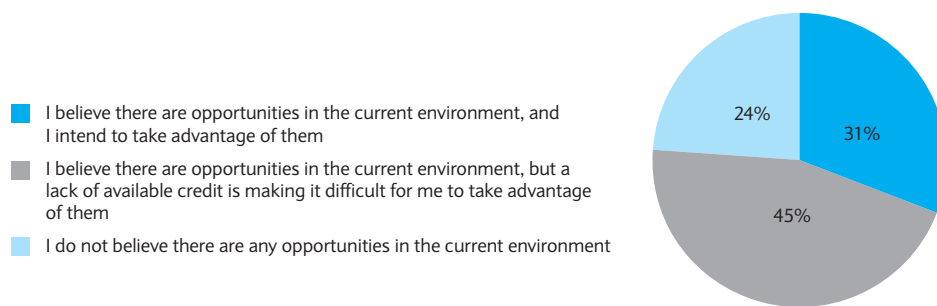
In all, 76 percent of investors say they perceive opportunities in residential real estate markets; however 60 percent of that total says a lack of available credit is making it difficult to take advantage of the opportunities, even though many wealthy

individuals buy with low levels of leverage. In most areas of the world, banks are providing much less mortgage financing, with lower levels of loan-to-value. There is slightly less optimism about the opportunities in commercial real estate — and credit here is a much bigger issue. A total of 68 percent of investors see opportunities in the current market, but three quarters

of that group say they are finding it difficult to take advantage of those opportunities because of a lack of credit. This finding demonstrates how important leverage had become in the commercial real estate market. Today, if debt is available at all for this type of investment, it is only available to the most experienced investors and developers with a proven track record.

**Which of the following statements best describes your current view of the global real estate market across the following categories? Residential**

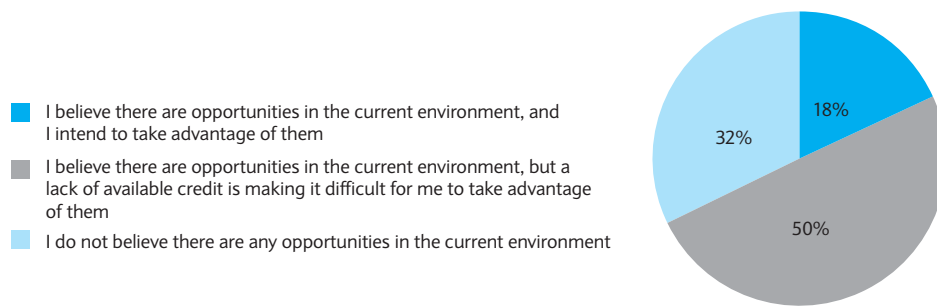
**Chart 7 – Attitudes to opportunities in residential real estate, all respondents**



Source: Economist Intelligence Unit Survey, September 2009

**Which of the following statements best describes your current view of the global real estate market across the following categories? Commercial**

**Chart 8 – Attitudes to opportunities in commercial real estate, all respondents**



Source: Economist Intelligence Unit Survey, September 2009

“There is no doubt that a certain amount of real estate can provide return enhancement and diversification benefits in most investors’ portfolios.”

**Philip Jeffcock**, Director, Real Estate at Barclays Wealth

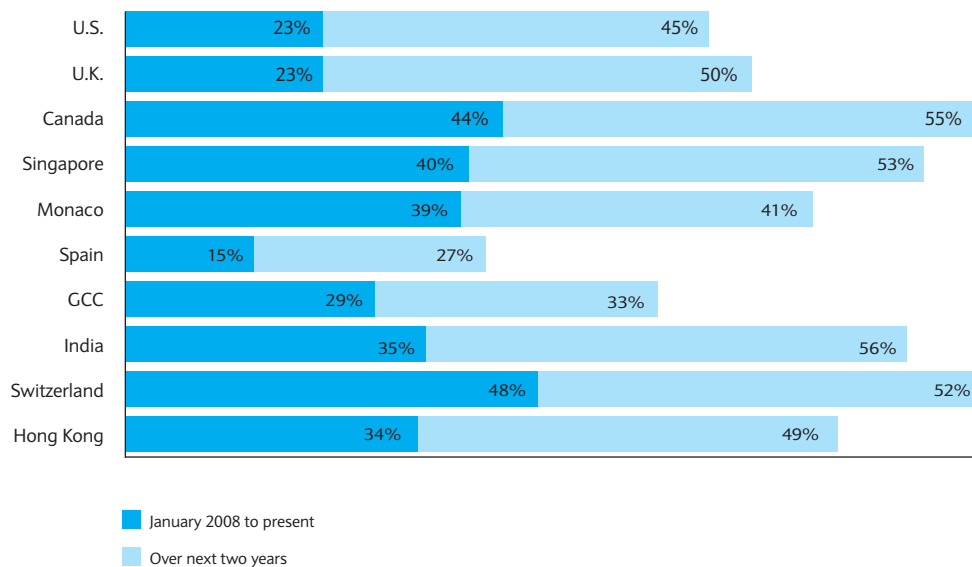
Aside from the availability of credit, investors need to be careful how they use leverage in their real estate investments, according to Mr. Jeffcock. “You are adding risk to what is already a very concentrated risk scenario,” he says. “You need to be careful that the risk-return relationships of your real estate portfolio match those of the rest of your portfolio. If you can reduce the level of leverage then you reduce the risk and you can therefore focus more on the returns.”

Another hurdle preventing investors from taking advantage of current opportunities is the expectation

gap between buyers and sellers — in other words, sellers still expect higher prices than buyers are prepared to pay. “What’s happened in the past three months is a lot of people have suddenly woken up and decided to buy some real estate,” says Angus McIntosh, a Partner and Head of Research at King Sturge. “But the problem is that now nobody wants to sell. So whereas there was quite a lot of stock around last Christmas and few buyers, now there are quite a few buyers and very little prime stock. The market is active for the best buildings; secondary investments are still very difficult to sell.”

**Since January 2008, has the market value of your real estate portfolio increased and do you expect it to do so in the next two years?**

**Chart 9 – Percent of respondents whose portfolios have increased/are projected to increase in value, by country**



Source: Economist Intelligence Unit Survey, September 2009

In general, there is guarded optimism among the high net worth respondents that their real estate portfolio will increase in value over the next two years. Just under half of respondents expect the value of their portfolio to increase, but only 23 percent expect a decrease, with the remainder expecting no change. Investors from Canada, Singapore and India are most bullish about the future; those from Spain and the GCC least so. Interestingly, investors from the GCC are also most likely

to increase their allocation to real estate. This suggests that they may have a longer time horizon, and do not necessarily expect prices to rise within the short to medium term. Of course, an increase in the value of a portfolio could be driven by two factors: first, the value of properties could be rising; but second, investors could be adding new properties to their portfolio, which our figures on allocation suggest could be the case for many individuals.

### The importance of local knowledge

Synergy Asset Management is a Geneva-based family office that manages money for several high net worth families in the Middle East and Europe. In 2008, Synergy, together with some private investors, set up the Landmark Real Estate Fund, a Swiss-based real estate investment fund that aims to provide solid, low-risk, steady returns in commercial and residential investment opportunities in Switzerland and other parts of Europe.

**“Real estate is a great asset, as long as you respect the fundamentals of location, quality of construction and sensible leveraging.”**

Issam Kabbani, Chief Executive of Landmark, is a strong believer that real estate should be a key part of an investor’s portfolio as part of a medium to long-term investment strategy. “Overall, we recommend that investors hold between 20 and 30 percent of their capital in yield-bearing real estate assets as opposed to new real estate developments. We propose a mix between residential and commercial properties yielding between four percent and eight percent in exceptional cases. Investors who can afford more risk and a higher return can have the option of participating in new developments, yielding between 25 percent to 50 percent on capital.”

Over the past year, Mr. Kabbani has noticed a huge increase in investor interest in Swiss real estate, as part of the flight to quality. “It was interesting to see that while many other markets were affected by the crisis, the Swiss market came off quite lightly. In Switzerland, we hardly registered any drop in prices — on the contrary, we have more bidders than before on properties that were for sale than we normally would have.”

Today, however, Mr. Kabbani thinks investors have become much more prudent. “I think following the crash many investors have gone back to fundamentals,” he says. “Real estate is a great asset, as long as you respect the fundamentals of location, quality of construction and sensible leveraging. But these were all forgotten during the bubble.”

Mr. Kabbani places a huge emphasis on the importance of local information and local partners. “On a given block in Geneva, you might have one or two buildings that are always in demand and generate a great yield but 50 yards down the street it doesn’t work and it’s completely different. This is true in all real estate markets. You need to have local alliances, otherwise you are exposing yourself to big risks.”

International investors also need to be aware of the impact of currency fluctuations. For example, dollar-based investors buying in Switzerland, who did not hedge their currency exposure, will have been hurt badly in the past year by the depreciation of the CHF.



# Section Two: Assessing the asset class

Direct residential real estate has many characteristics that set it apart from other, more traditional asset classes. For many it seems to be a very long-term investment that is measured over decades rather than years, although that may have been forgotten by some during the real estate bubble. It is tangible and, to many investors, its permanence offers a perceived security that they may feel is lacking with other asset classes.

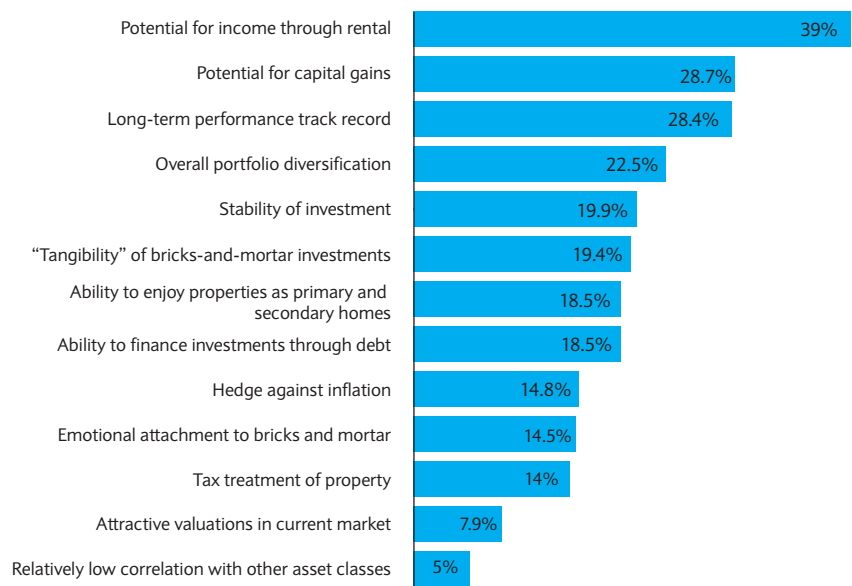
But there are significant challenges with holding residential real estate in a portfolio that can cause problems for investors. “People have a natural affinity for real estate,” says Rory Gilbert, Head of U.K. High Net Worth, U.K. and Ireland Private Bank at Barclays Wealth. “But investors need to be wary, as this is an inefficient market with low price transparency, illiquidity and high transaction costs.”

When asked about the main advantages of holding residential real estate in their portfolio, survey

respondents point to the potential for income through rental as the biggest attraction. This was a finding that surprised many of the experts questioned for our in-depth interviews. In general, residential real estate offers relatively low levels of returns, especially when compared with commercial real estate. The consensus of the experts was that residential real estate is best seen as a source of capital growth, rather than of income.

Which of the following factors do you consider to be most attractive about holding real estate investments in your portfolio?

Chart 10 – Key advantages of investing in residential real estate, all respondents



Source: Economist Intelligence Unit Survey, September 2009

“Yields on residential real estate will never compete with commercial real estate,” says Willie Gething, Executive Chairman of Lennox Investment Management, an independent adviser that helps wealthy investors buy properties. “Today in central London, for example, you get yields of maybe four percent for prime real estate. You don’t buy residential real estate for income. The yield merely helps you to service sensible levels of debt. Its real potential is for capital appreciation.”

Indeed, this is seen by survey respondents as the second biggest advantage of investing in real estate, followed by the long-term track record of residential real estate. Demographic pressures and demand for land will, over the long term, continue to support residential real estate as an investment, believe some interviewees. “People are always going to need somewhere to live,” says David Salusbury, Chairman of the National Landlords Association. “And they aren’t making land anymore, as the saying goes. So I personally don’t believe as a landlord, that if you do it properly over the long run, you’re going to go far wrong.”

There is no doubt that residential real estate offers some diversification possibilities, but many experts believe that investors do not always think about this characteristic as systematically as they might with other assets. “We very

often see wealthy investors who have portfolios with an unhealthy concentration of one or two prestige properties, a Manhattan penthouse or house in Belgravia, which often accounts for a large proportion of their real estate holdings,” says Mr. Demeroutis. “These investors would be better to spread their investment across different markets and asset types.”

He suggests that investors should consider low-income or student housing across a spread of geographical locations. “Your real estate investment doesn’t have to necessarily look like somewhere you would like to live. In fact, that can be a dangerous investment philosophy. There are big concentration issues when you invest in one very expensive real estate in terms of risks: fire, environmental, market and so on.”

### A personal relationship

This highlights a broader point, whereby investing in real estate is about much more than a pure financial investment. Residential real estate has a special place in private investors’ hearts, as well as their portfolios. For a wealthy investor, residential real estate is seldom treated simply as an asset.

“Real estate is best seen as a composite good,” says Ms. Barnes. “It provides a range of different functions for a real estate buyer. Clearly it is an investment asset. And there is an element of utility as people live in these properties. But there are also elements of lifestyle, luxury and fashion that play a role in the decision. Buyers tend to have a strong, often intense, emotional connection with their houses, even if it is not their principal residence.”

This emotional relationship with real estate inevitably impacts the way investors deal with their real estate investments. According to Mr. Gething, there are several ways this can play out. “Buyers may be inclined to buy somewhere they find very attractive to them personally which may or may not be a good investment. They may pay more for it than a dispassionate buyer. And they may not sell it when a return is offered that a dispassionate investor would be happy to take. The unshakeable rule maintained by the best real estate investors is never to fall in love with an asset.”

The risk of holding on to an asset too long is one that emerges from the survey. Asked how they manage real estate compared with other investments, just 33 percent say that their willingness to sell would be greater than with another asset class should circumstances change. In other words, while investors may offload equities and other asset classes should the need arise, they are less likely to do the same with

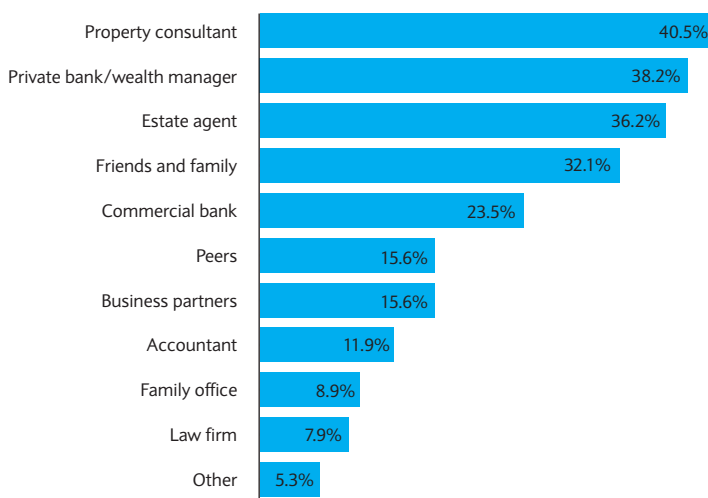
residential real estate — partly because it is a long-term, illiquid investment, but also partly because they develop an emotional attachment to it. Similarly, the survey found that just 18 percent of respondents would hold real estate in their portfolios for less time than other asset classes, supporting the idea of real estate as a long-term commitment.

For most people, buying a house is one of the biggest financial investments that they make, yet investors often pay less attention to this decision than they would do with other comparable investments. The survey suggests that even highly sophisticated private investors may take a relatively simple approach to managing their residential real estate investments: they often make decisions independently of any advice or, if they do seek a second opinion, they rely on friends and family or estate agents. Professional, independent advice, according to the survey, is not always sought, which suggests that investors could do more to improve the rigor of their investment process.

For example, almost one-third of investors rely on advice from their family and friends (although they are not the most widely consulted source of advice). Friends can be very influential on buying decisions, if not always from a financial perspective. “For many wealthy real estate buyers, the opinion and values of their peers matter a lot,” says Ms. Barnes.

**Which of the following sources of advice do you turn to in order to assist you with your real estate investments?**

**Chart 11 – Sources of advice on real estate investment, all respondents**



Source: Economist Intelligence Unit Survey, September 2009

Other interviewees suggest that investors may be less than rational in their buying decisions. “I think real estate as an asset class is where the worst elements of behavioral finance rear their head,” says Mr. Demeroutis. “Vanity is a huge factor in the purchase of residential real estate, although buyers are reluctant to admit this. There are clearly so many other reasons that people buy real estate besides as an investment, although they may say that it is an investment.”

“The residential real estate market is a jungle populated by some rather wild animals: the developers, the agents, the owners.”

Many investors will not take any advice at all when buying real estate, preferring to go with their own opinion and instinct. This is something that constantly surprises Mr. Gething. “Not many people would spend \$2m (£1m) on buying a painting without taking any

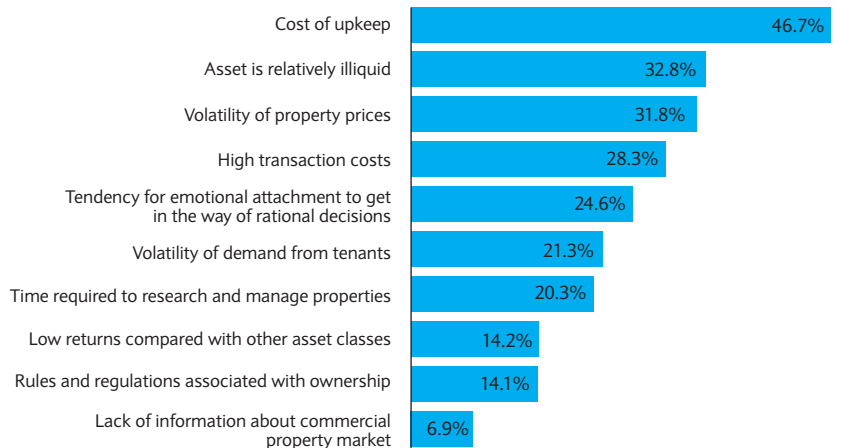
advice, but I have seen people spending \$8m (£5m) on real estate without getting any advice,” he says. “The residential real estate market is a jungle populated by some rather wild animals: the developers, the agents, the owners. Some are very good and highly professional. But many are not. It’s completely unregulated — it really is a case of buyer beware.”

Mr. Nouvion highlights the importance of getting appropriate advice — and taking the views of some in the market with a pinch of salt. “You often find when your real estate is being sold that the agent tells you that the real estate is a mediocre one, but if you are on the buying side, it’s suddenly the world’s best,” he says.

There are interesting differences between men and women when it comes to residential real estate investments. Women are much more likely to rely on friends and family as a source of advice than men — indeed, it is their most widely consulted source of information. They are also more likely than men to say that they find investing in real estate more enjoyable than other asset classes, and are less likely to invest indirectly, through funds.

**Which of the following factors do you consider to be the biggest disadvantages of holding residential real estate investments in your portfolio?**

**Chart 12 – Disadvantages of holding residential real estate, all respondents**



Source: Economist Intelligence Unit Survey, September 2009

## Knowing the risks

One of the lessons from the financial crisis is that, as an investment, real estate has certain limitations or disadvantages which many investors did not take into account, including the fact that its correlation with other asset classes may increase in times of stress. High net worth individuals should consider these carefully before making a commitment.

Cost of upkeep is cited as the biggest disadvantage of residential real estate. “There are all kinds of maintenance required when you come to residential real estate,” says Mr. Gething. “You need to be willing to set aside up to 20 percent of gross rents to cover this.”

Residential real estate’s relative lack of liquidity is also cited as a major disadvantage. During the boom years, this was a characteristic of real estate investment that many investors seemingly forgot. “I think many investors got used to the idea that you could have both high returns and high liquidity at the same time,” say Audrey Klein, Managing Principal at Park Hill Estate, a subsidiary of Blackstone. “But that has always been anomalous. And what we saw was that a lot of the so-called liquidity that investors thought they were getting rapidly disappeared when there were problems.”

## Defying the downturn

There can be few areas of the world that show so clearly the dangers of over-development than the skyline of Dubai, which once had the highest concentration of construction cranes in the world. Today, the cranes are idle, the market has stalled and there is a new mood of sobriety.

“Just a couple of years ago, anyone could buy a piece of land and become a developer,” says Ahmed Al Hatti, Chairman of Cayan Investment and Development, a leading regional construction company. “Today, everything has changed. It is much more focused on quality of project, location and the developer’s previous projects. But for established, successful developers with a good track record, there are good opportunities.”

In an environment where developers have slowed down, closed or indeed gone under, Cayan is still expanding and recruiting. Cayan is focusing a lot of attention on the Saudi market, which Mr. Al Hatti

believes has many interesting characteristics, including demographics. “There is a population of around 27 million people with some 40 percent of the population under the age of 15,” he says. “As a result, there is a big demand for accommodation and a government that is working hard to develop the mortgage market.”

The demographic and regulatory changes currently underway in Saudi Arabia could represent a valuable opportunity for investors. In a report published in late 2008, Jones Lang LaSalle forecasted significant growth in both the residential and commercial real estate sectors in the country. They highlighted a number of important drivers of growth, including new mortgage laws aimed at solving the current lack of mortgage financing and extending home ownership, a shortage of residential units, and growth rates in the office sector that are ahead of those in other GCC countries.

## Commercial

Commercial real estate plays an important role in the portfolio of many wealthy investors. Among the wealthiest survey respondents, who have more than \$48m (£30m) in financial assets, 70 percent have some exposure to direct commercial real estate investments.

According to some interviewees, the commercial real estate market in some countries is currently looking attractive. “I think it may be a good time to buy commercial real estate which is prime — well located, good quality and let to tenants with good covenants on long leases,” says Charles Beer, a Senior Partner in Real Estate Tax at KPMG in the U.K. “Supplies of such real estate are very limited, however.”

The commercial real estate market is very different from the residential market. For one thing, the investment sizes are substantially larger; it is hard to get a foothold in the market for much less than \$8m (£5m), according to Sean Brew, Head of Portfolio Asset Management at global real estate adviser, DTZ. In addition, it is in many respects considerably more sophisticated. Aside from ultra high net worth individuals, buyers tend to be institutional funds or corporate buyers, who will research investments very carefully and manage their portfolios on a continuous basis. To compete in this market, individual investors need to adopt a highly professional approach.

“In my experience, private investors in commercial real estate as a group are highly entrepreneurial,” says Mr. Brew. “They are risk takers and they know what they want. They are very proactive.”

The main advantage of investment in commercial real estate, according to respondents, is the yield that can be obtained through rental. With many other assets yielding relatively low returns as a result of record low interest rates, the returns from commercial real estate can look attractive. Certainly, yields on commercial real estate are higher than in residential, because businesses are prepared to pay more for space in a good location that helps them achieve their goals. This makes commercial real estate more suitable for generating income, but some experts caution against high expectations.

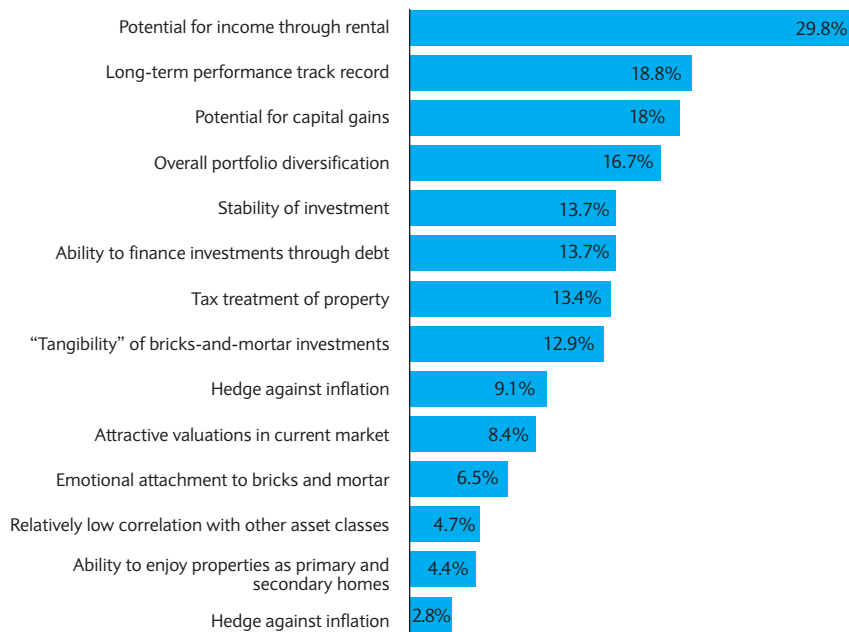
“With unemployment still rising, vacancy rates on commercial real estate remain high, which means that there is a risk that the investment will yield no income at all.”

“Commercial real estate is now providing good value and, when people look at returns from other investments, yields look attractive,” says Ian McBryde, Director of Property Funds at F&C REIT Asset Management. “However, people need to be reminded that some of the underlying fundamentals such as tenant demand and vacancy rates are still not strong.”

With unemployment still rising, vacancy rates on commercial real estate remain high — for example, the void rate in the U.K. is now at an all-time high, which means that there is a risk that the investment will yield no income at all. Investors should be aware that downturns in commercial real estate can last for years, rather than months; this is because commercial properties take several years to develop, which can lead to a significant lag between supply and demand.

Which of the following factors do you consider to be most attractive about holding commercial real estate investments in your portfolio?

Chart 13 – Key advantages of commercial real estate investment



Source: Economist Intelligence Unit Survey, September 2009

“I am less optimistic about commercial real estate in general, at least from an equity perspective,” says Mr. Demeroutis. “I think there are some huge unresolved problems overhanging the sector that I don’t think anyone is dealing with — it will take time and money to put this right. It’s fine if you can find well-let buildings in the West End or Times Square with good tenants, but there is a limited supply of properties like this.”

Mark Carpenter, Director of the Property Division at Henderson New Star, a fund manager, is more optimistic about some markets’ ability to recover quickly. “Some markets are bouncing back quickly while some are still experiencing severe problems,” he says. “The U.K. was the first to drop, in Q2 2007, while some in the Far East and better quality properties in western Europe didn’t experience declines until at least 12 months later. And as there was a time lag on the way down, we thought there would be a mirror in the recovery. But other areas are showing faster improvement than the U.K.”

Mr. Carpenter is particularly bullish on the Far East, partly due to a change in demand. “These are still growth economies, even though the growth has slowed,” he says. “In Q4 2008, after Lehman’s

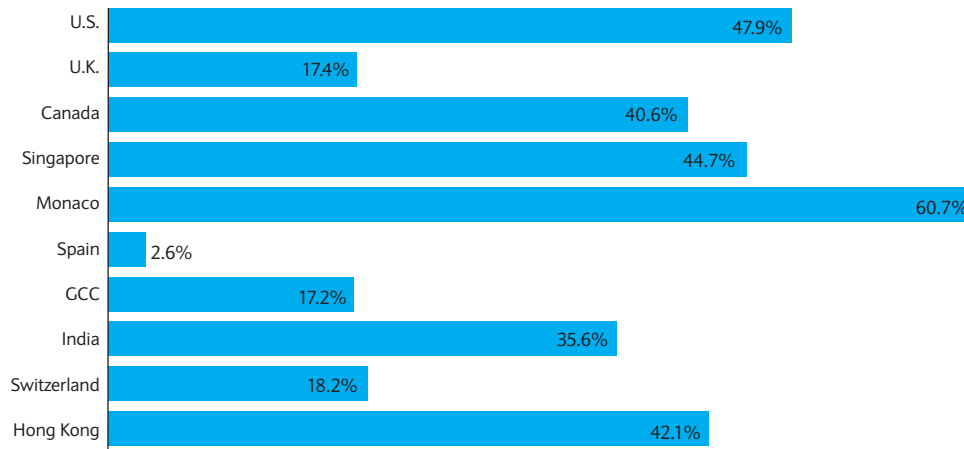
bankruptcy, yields were hit by 200 basis points and international demand dried up, led by the North Americans and Europeans. However they are now being replaced by local wealthy individuals and corporations, who are not very leveraged. It’s an interesting change with the local players becoming the drivers and nudging prices up.”

### Choosing the right investment vehicle

Diversification remains important in commercial real estate but it can be difficult to achieve through physical holdings due to the large sums of money involved, except for the very wealthiest investors. But the growth of real estate funds allows investors to achieve diversification across multiple types of real estate and location with smaller investments, and to gain access to the expertise of specialist managers. “In order to get the kind of diversification that we think real estate as an asset class needs, and not get tied to some very specific risks, it’s crucial for investors to pool their money in some kind of fund structure to buy a larger, more diversified pool of assets,” says Mr. Gilbert.

Which of the following types of real estate investment do you hold in your portfolio?

Chart 14 – Respondents who held indirect investments in real estate, by country



Source: Economist Intelligence Unit Survey, September 2009

Among the survey respondents, 30 percent say they hold indirect real estate investments such as mutual funds and REITs. However, there are wide variations in indirect holdings among the target countries. Investors in Monaco are most likely to invest in real estate indirectly, with 61 percent having holdings. Investors in the U.S. (48 percent), Canada (41 percent), Singapore (45 percent) and Hong Kong (42 percent) also favor indirect investments, while the U.K. and GCC are lukewarm, with just 17 percent having indirect real estate investments. Spanish investors are the least likely to invest indirectly, with just 3 percent having these holdings.

The survey also found that the wealthiest respondents — those who in theory are most able to make direct investments in commercial real estate — are the most likely to invest indirectly. Almost 45 percent of respondents with investable assets in excess of \$48m (£30m) hold indirect investments, while just 26 percent of respondents with \$800k to \$2m (£500k to £1m) invest indirectly. This may be due to better quality

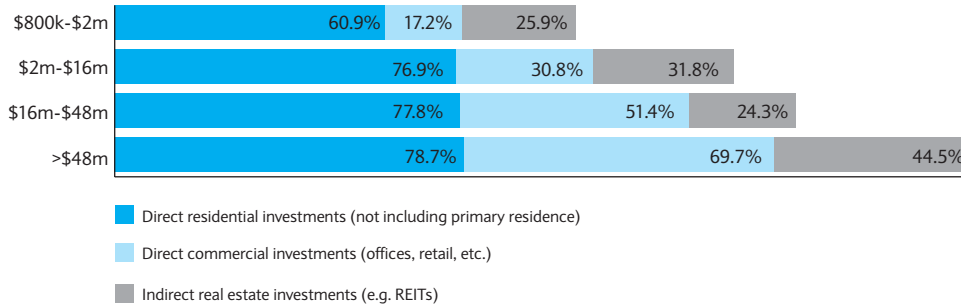
advice received by the wealthiest or it may be due to the fact that the wealthiest will have more investments — they are also the most likely to hold direct commercial real estate, with 70 percent of respondents with assets in excess of \$48m (£30m) holding directly while just 17 percent of respondents with \$800k to \$2m (£500k to £1m) having direct exposure.

**“The survey also found that the wealthiest respondents are the most likely to invest indirectly.”**

There is also an interesting divide between the sexes. While 34 percent of male survey respondents hold indirect real estate investments, just 14 percent of female respondents do.

Which of the following types of real estate investment do you hold in your portfolio?

Chart 15 – Percent of respondents holding different types of real estate investments, by wealth band



Source: Economist Intelligence Unit Survey, September 2009

While real estate funds offer a lower entry point for investment in commercial real estate and diversification, they are not without their problems. Their liquidity is often cited as an advantage — it is much easier to get out of a mutual fund than sell real estate — but investors need to read the fine print and understand each fund’s rules on redemptions.

For example, U.K. investors were caught out in late 2007 and early 2008 when some real estate funds were forced to suspend redemptions, and sometimes trading entirely, as a result of lack of liquidity. Most funds tended to keep between five percent and ten percent in cash in order to meet investor redemptions, but when a wave of investors decided they wanted out, the funds were unable to cope, shrinking cash levels significantly and forcing the sale of real estate. “It was a psychological thing — people panicked,” says Mr. McBryde. “At the time, it was like a run on a bank but most retail funds are now stable and seeing positive inflows.”

Problems such as these have led investors to question which type of fund structure is best suited for real estate investment. Open-ended funds, at the end of every day, issue shares to new investors and buy back shares from investors wishing to leave the fund — with inflows and outflows often canceling each other out. But when outflows greatly exceed inflows, and the cash cushions funds keep are depleted, there are problems.

This has led some investors to prefer closed-ended vehicles, such as real estate trusts or REITs. These funds have a set number of shares, so once they are all in circulation investors must purchase them on the secondary market rather than from the fund manager, and shares are not normally redeemable for cash or securities until the fund liquidates. This means that the fund manager is not forced to sell real estate in order to meet redemptions, and investors may sell their shares at any time — provided they can find a buyer. However, listed trusts and REITs are more correlated to equities than direct real estate investments or open-ended funds, because they are also traded on the stock market.

The key is for investors to know what they are buying and for real estate managers to be clear in their communications. “Institutional investors understand that real estate is a long-term investment and that transactions are expensive and take time,” says Mark Meiklejon, Investment Director at Standard Life Investments. “But this can be a problem in the retail investment space if they don’t understand that direct real estate is illiquid. This has raised issues with some managers around how they communicate this to investors.”

## Time to put reason before emotion

Real estate prices are showing early signs of stabilizing in some major developed countries and, in other markets such as China, prices are even booming. This is an environment that offers considerable promise, although tight credit conditions will continue to hinder investors' ability to take advantage of these opportunities.

The survey showed that high net worth individuals in most markets around the world are cautiously increasing their allocation to real estate — or at least maintaining their current allocation — although they recognize that prices may still have further to fall in the short term. These findings and the opinions of our panel emphasize the need to be highly selective with real estate investments, and to remember that the asset class should be regarded as a long-term investment, not a source of quick gains.

**“Institutional investors understand that real estate is a long-term investment and that transactions are expensive and take time.”**

Most investors in our survey currently focus on real estate in their home country, no doubt because it feels familiar to them, and because information about local markets is more readily available. But when investors do look outside their own countries of residence, most consider the U.S. to be the most attractive real estate market, followed by China, the U.K. and India. This is an interesting and complex mix of established and emerging markets. Two of them (the U.S. and U.K.) have witnessed steep declines in real estate prices in

recent years and face a long-haul recovery, whereas China and India are expected to deliver rapid economic growth that in turn should fuel demand for real estate.

There is always a danger with real estate investment, at least in the case of residential, that the heart can rule the head. Emotional attachment can get in the way of sound decision-making, leading investors to buy assets because they like them or hang on to them for too long when circumstances change. When investing with financial goals in mind, investors must disassociate themselves from these emotional attachments and take an objective view.

This is especially important when it comes to diversification, both in terms of overall portfolio diversification and diversification within the real estate component. In order to spread their risk and gain access to a wider spectrum of real estate markets, investors should carefully consider their options, either by taking a more international view, adding commercial real estate to their portfolio or investing indirectly through funds, which less than a third of investors currently do.<sup>5</sup>

Investors must be careful to avoid overexposure to an asset class that in practice has been proven to be vulnerable to booms and busts. So while it can be tempting to seek refuge in real estate as a safe haven, especially given the current widespread mistrust in complex financial products, investors must remember that the tangibility of bricks and mortar and their apparent promise of stability can sometimes prove illusory.

5. Diversification does not guarantee against loss

“Real estate prices are showing early signs of stabilizing in some major developed countries and, in other markets such as China, prices are even booming.”

## The Barclays Wealth View

*Contributed by Michael Dicks, Chief Economist at Barclays Wealth, who has over 20 years of experience researching housing and real estate markets. Here he provides his opinions on some of the survey findings.*

We found a number of the survey's findings surprising. Most obviously, survey respondents are clearly holding a much higher proportion of their wealth in real estate than we would normally advise.

Investors need not only to diversify more into other asset classes, but also to make sure that their real estate portfolios are themselves much less concentrated than they seem to be. Survey respondents' real estate portfolios also appear to suffer from "home bias" (i.e. a tendency to be too strongly tilted towards the individual investor's home market). So they need to be better diversified on a geographical basis.

Survey respondents also seem to believe that, as an asset class, real estate delivers high long-term returns, when, in fact, it typically has not done so. When considering risk-adjusted returns, the asset class does not score very well either. Investors appear to believe that housing provides a "safe" investment, when it clearly does not: witness, for example, the near one-third decline in the real value of housing in the United States over the past two years — and similar declines have occurred in 15 other economies that have experienced banking crises in the last three decades. Linked to this, survey respondents' expectations of high rental returns from investing in residential real estate seem to us to be very unlikely to be forthcoming, as most other experts surveyed in the report suggested too. However, in some areas, investors' misperceptions may work in the other way. Capital gains expectations for example, are typically extrapolative, and hence normally overly optimistic at the top of the cycle and overly pessimistic at the bottom of one. So currently the asset class is probably more attractive than generally believed from this perspective. Both on a strategic asset allocation and tactical asset allocation basis, our U.S. strategy team recommends clients be underweight in this asset class.

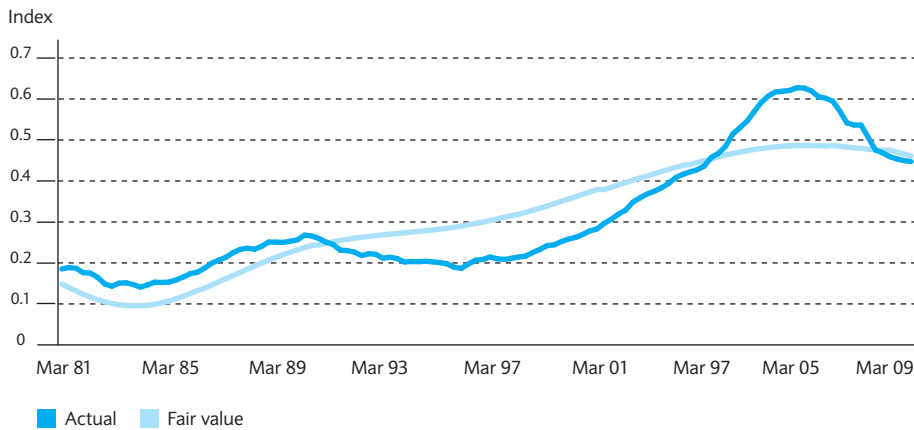
Investors may find it useful to consider their real estate holdings in light of our forecasts for the sector, summarized below, and detailed in our quarterly *Signpost* publication.

### Residential real estate outlook

We are keen to differentiate here between the U.S. and U.K. markets. We believe that the drop in U.S. house prices has been sufficient to take them back to "fair value" (i.e. what is justified by the economic fundamentals). We forecast a slow recovery in prices over the medium term, but would not be surprised if prices "bounced along the bottom" for a while yet. In the U.K., prices have not yet fallen back to "fair value." Because of this, the recent recovery in U.K. residential real estate prices looks suspect in our view. The two charts on page 33 illustrate these points.

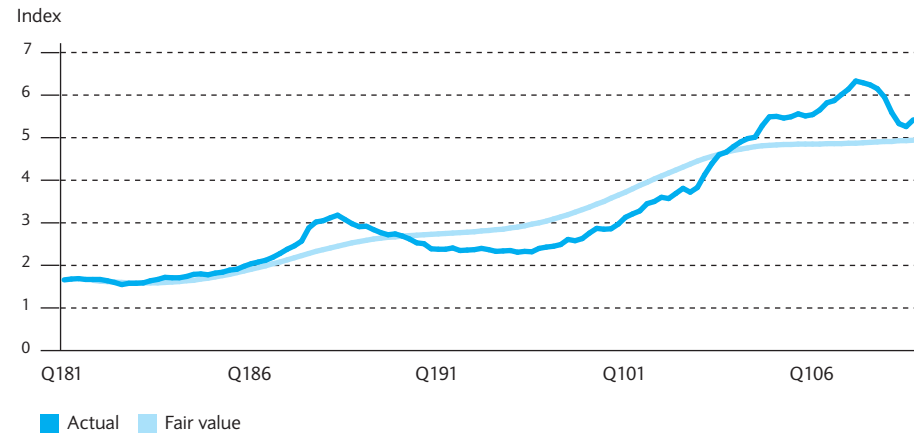
Two other observations are of relevance here. First, one should place the most emphasis on analysis of the higher quality official housing prices data, rather than being diverted by some of the private sector data series that may be narrower in focus. Second, we believe that the top end of the real estate market in the U.K. could continue to do better than the market as a whole, because, thanks to the fall of sterling, top-end real estate may now look cheap to a foreign investor who has benefited from sterling's decline over the past year or so. But foreign investors in U.K. real estate should also be aware that they are taking a lot of currency risk, as a further fall in the value of sterling cannot be ruled out. An investor may want to hedge this position accordingly.

**Chart 1 – U.S. residential house prices: actual vs. “fair value”**



Source: Barclays Wealth Economics

**Chart 2 – U.K. residential house prices: actual vs. “fair value”**



Source: Barclays Wealth Economics

## Commercial real estate outlook

We are keeping a close eye on trends in real estate investment trusts (REITs) — which are a leveraged form of equity investment. Accordingly, it is not surprising that these have roared back since troughing in early March. The FTSE NAREIT U.S. Real Estate Index Series has risen by more than 70 percent between March and October — although it is still well shy of its previous peak.

Despite recent rises, we believe that both U.S. and U.K. markets are still somewhat below their “fair values,” therefore we expect further gains in these

two REITs markets in 2010, and believe that Europe and non-Japan Asia look to be a good value too. For further details, see the October edition of our quarterly *Signpost* publication.

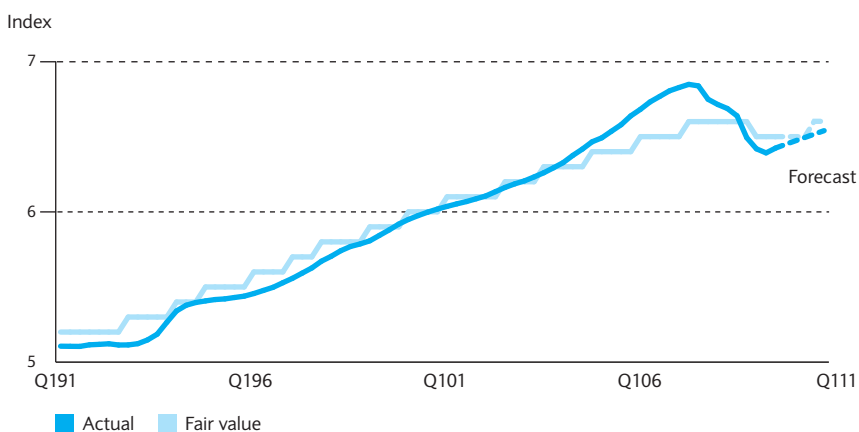
REITs are of course, only one way to invest in commercial real estate. We also monitor and analyze the IPD’s commercial real estate series, which are designed to track underlying investment performance in the sector. The U.K. series appears to be something like ten percent below “fair value” currently, as shown in Chart 3. So, we are a little less optimistic on investments based around the IPD series, than those in REITs.

Formal investment modeling is difficult for one-off commercial real estate transactions (i.e. those outside of those covered by the liquid public investments in REITS or the Investment Property Databank (IPD) series). But we believe that there are opportunities here too for the careful investor.

In our most recent analysis of commercial real estate<sup>6</sup>, we focus on the U.K. market — arguing that there is scope for further gains in both rental and capital values. These forecasts have the following implications, if they are correct. In the short term, overexposure to real estate in a portfolio

may not matter; if our forecast is correct and prices rise further, investors will make money. But this does not undermine the previous observation that many survey respondents look over-committed to real estate from a strategic perspective. Looking beyond the next quarter or two, we believe that investors ought to be using the opportunity to take profits on the more liquid and lower-transaction cost elements of their portfolio. We would like to stress the advantages of a tailored approach to portfolio management, with a clear distinction between short-term (tactical) and long-term (strategic) asset allocations.

**Chart 3 – The U.K. IPD commercial property returns series**



Source: Barclays Wealth Economics

6. *Compass*, September 2009 (Europe, Middle East and Africa edition)

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