

## Real estate securities and common stocks: A first international outlook

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For real estate investors with an international view, the shares of listed real estate companies offer interesting investment opportunities. The market for these shares has grown more than twelvefold during the last decade and a half, and is now over U.S. \$350 billion in size. Moreover, there has been a major increase in the number of countries in which listed property companies exist. It is now possible to buy an indirect (securitized) property portfolio with a composition that closely matches individual investor preferences, both in terms of countries, regions, and property types.

#### **Why International Real Estate Investment Should Be Done with Public Securities**

Compared to directly held real estate, the liquidity of property shares is a major benefit. This benefit means even more for foreign investors than for domestic investors, because the administrative costs to buy and sell sometimes increase with distance and across country lines.

Buying the public shares of domestic property companies also circumvents some of the information problems inherent in international investment in directly held real estate properties. Because directly held real estate is traded on non-public markets, these markets are probably not as informationally efficient. Less informed out-of-town investors sometimes pay too much for properties, and tend to buy more lemons than their informed local competitors. This translates into lower risk-adjusted returns. Buying the publicly traded shares of these local competitors, however, avoids most of these information problems, especially when the incentives and interest of local firms and non-local shareholders are well aligned.

Another reason why securitized international property investment is a good idea is that it involves less monitoring costs than direct investments. It is not necessary to travel great distances to look after buildings and the managers of those buildings. A securitized property investor has local co-investors with positions in the same stocks, which helps take care of the monitoring problems.

Compared to common stocks, real estate securities show a big potential for risk reduction by international diversification. Eichholtz [1996] shows that international correlations among real estate securities markets are lower than correlations among stock markets. This may be because real estate markets are more influenced by local factors than the stock markets. This implies, however, that international investment is even more important as a diversification strategy for real estate investors than for investors in common stocks.

#### **Yes, But Real Estate Securities Are Just Like Stocks**

In short, the evidence shows that international real estate investment is important, and should be accomplished through purchasing real estate securities. The standard counterargument is the notion that real estate securities are not real estate, per se, but stocks, and an investor who already owns stocks may not be helped by adding them to a portfolio.

Whether this is true depends on the correlations between common stocks and real estate securities, and recent evidence for the U.S. shows that these correlations are coming down, for a number of reasons. For example, real estate securities markets are getting more sophisticated, information about these securities is becoming more readily available, and the liquidity of these markets is increasing. As a result, property shares will be priced more like the underlying real estate than like the stock market on which they trade (see Khoo, Hartzell, and Hoesli [1993]).

The purpose of this article is to investigate the relationship between real estate securities and common stocks internationally. For countries with a sizeable securitized real estate market, the correlation between stocks and securitized real estate will be presented, together with information about average returns and their volatility. Before moving on to a country level, however, a brief discussion of some global trends will help provide a useful background.

### **Are They Really Just Like Stocks?**

For international comparison between real estate securities and common stocks, this study uses data from two sources. The stock returns are from Morgan Stanley Capital International (MSCI). Data on the country level and continental level are compared. For all countries and continents for which MSCI provides data, the matching return index of property shares from the Global Real Estate Securities Database of Global Property Research (GPR) is used.

For the continental indexes, this means that MSCI and GPR include the same countries. In all, this study uses data for nineteen countries in three continental areas, Europe, North America, and the Far East.[\*] A sizeable real estate securities market exists in most of these countries. All data are total rate of return in local currency and in U.S. dollars and have a monthly frequency. All returns are from January 1987 through December 1996.

To get a first look at the interdependence between property security returns and stock returns, Exhibits 1 through 3 provide plots of the two matching indexes for Europe, North America, and the Far East. For all three areas, it appears that a positive relationship exists. Judging by the graphs, the interdependence appears stronger for the Far East than for Europe and North America. The graphs also suggest that this relationship is stronger at the beginning of the ten-year period than at the end. This is especially true for North America and Europe, but for the Far East, signs of the same development are visible in Exhibit 3.

### **Correlations Vary Greatly Over Countries**

To get a better understanding of the relationship between securitized real estate and common stocks, Exhibit 4 provides correlations between GPR and MSCI returns for each country and continent. Correlations are given in local currencies and in U.S. dollars, reflecting the hedged and unhedged situations, respectively.

For North America, correlations between real estate security returns and stock returns are 0.56 for Canada and 0.72 for the U.S. if returns are expressed in local currency. In U.S. dollars, the correlation for Canada is 0.62.

For the European countries, the correlations vary substantially. For Austria, Germany, and Switzerland, they are very low: 0.12, 0.13, and 0.35, respectively. This is due to the nature of most real estate companies in these three countries. The companies are open-ended, which implies that they are traded at net asset value, the level of which is determined by appraisals and the companies themselves. The return patterns of their shares are therefore much like appraisal-based real estate indexes, and exhibit the same low correlations with the returns on other assets.

Other European real estate securities markets like Belgium, the Netherlands, and Norway also show relatively low correlations with their stock market. For these countries, correlations are about 0.4. Property companies in the U.K. have the highest correlation with their stock market. Expressed in local currency, it is 0.80. The correlation patterns in Europe do not change very much if we go from local currency to U.S. dollars.

The correlations in the countries from the Far East are relatively high. They vary between 0.56 for New Zealand and 0.96 for Hong Kong. Again, the currency used does not alter the correlation patterns much.

So, on average, the Far Eastern real estate securities markets show much higher correlations with their stock markets than the countries in Europe and North America. The question is, how can this be explained?

### **What Causes the Differences?**

First, it appears that the real estate securities markets, which show relatively weak dependence on their national stock markets, are, on average, more mature than the relatively young markets of the Far

East. This maturity argument agrees with previous research and intuition. The more mature a market is, the more information is available about the traded real estate companies, and the more they are priced like the underlying real estate. Although the analysis done here is not very robust, this finding gives some international support for the findings of Khoo, Hartzell, and Hoesli [1993]. If this issue is important, correlations can be expected to decrease in time with the increasing maturity of the real estate securities market.

The second possible reason for high correlations in the Far East is that property companies play an important role in the stock markets of many countries in this region. In countries like Hong Kong and Singapore, the level of real estate securitization is much higher than in the European and North American markets. The MSCI common stock index used here reflects this point. This means that the correlations probably overestimate the relationship between property stock returns and the returns on other stocks.

The third reason why the Far East differs from Europe and North America in this regard is that the GPR-LIFE indexes used here are combined investor and investor-developer indexes. Pure developers are excluded. In the GPR data base, property companies are defined as investors if they get more than 75% of their revenues from a real estate investment portfolio. Investor-developers get more than 75% of their revenues from a combination of investment and development activities.

In Europe and North America, investor-developers are much less important in the indexes than in the Far East. Because it is likely that pure property investments are priced more like real estate, and that property developers are more closely attuned to the stock market at large, this may explain why correlations between real estate securities returns and stock returns are so high in the Far East. It also implies that real estate securities investors who limit themselves to property investment companies can achieve bigger diversification benefits than the correlations presented in Exhibit 4 suggest.

### Conclusion

Our main point is that the relationship between real estate securities and the stock markets on which they trade varies substantially over countries. For most of the European countries, the correlations between real estate securities and common stock returns are relatively low. They vary from 0.12 for Austria to 0.80 for the U.K. For North America, the picture is similar. This contrasts sharply with the situation in the Far East, where these correlations are much higher, and vary between 0.56 for New Zealand and 0.96 for Hong Kong.

What does this imply for investors who are already involved in international equity investment? Should they include real estate securities in their portfolios, and if so, does this add value? The answer is that including real estate securities probably adds more value than the correlations suggest.

High correlations can be at least partly explained by the fact that property companies play a relatively important role in the general stock indexes for the Far Eastern countries, as well as by the nature of the property securities indexes used. The correlations between property investment companies and non-property stocks is therefore probably lower than the correlations presented in this study.

The other possible explanation for high correlations is the immaturity of real estate securities markets. The nice thing about immaturity is that it usually disappears. This could mean lower correlations and more effective international mixed-asset diversification through real estate securities in the future.

### Endnote

The standard MSCI Far East Index does not include New Zealand and Australia, which is why the MSCI Pacific index is used here.

Legend for chart

A-Local Currencies

B-U.S. Dollars

C-Start Date

Exhibit 4

Correlations Between Real Estate Securities and Common Stock

Returns January 1987-December 1996

	A	B	C
World	0.85	0.84	1-87

Europe	0.82	0.77	1-87
Austria	0.12	0.23	1-89
Belgium	0.38	0.39	1-87
France	0.61	0.61	1-87
Germany	0.13	0.30	1-87
Italy	0.64	0.69	1-87
Netherlands	0.36	0.37	1-87
Norway	0.43	0.38	1-87
Spain	0.53	0.56	3-89
Sweden	0.59	0.51	1-87
Switzerland	0.35	0.41	1-87
United Kingdom	0.80	0.82	1-87
North America	0.71	0.70	1-87
Canada	0.56	0.62	1-87
United States	0.72	0.72	1-87
Far East	0.79	0.79	1-87
Australia	0.76	0.81	1-87
Hong Kong	0.96	0.93	1-87
Japan	0.83	0.85	1-87
Malaysia	0.80	0.77	1-87
New Zealand	0.56	0.58	1-88
Singapore	0.93	0.89	1-87

Source: Global Property Research.

GRAPH: Exhibit 1: GPR-LIFE Europe versus MSCI Europe 14

GRAPH: Exhibit 2: GPR-LIFE North America versus MSCI North America

GRAPH: Exhibit 3: GPR-LIFE Pacific versus MSCI Pacific

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