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Overlooked Opportunities in International Real Estate

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There are many possible benefits to investing in real estate securities, including portfolio diversification, income, inflation protection, the potential for competitive returns, as well as liquidity and transparency.[1] However, when investing in real estate, investors tend to focus on their home country or region, overlooking significant opportunities that exist internationally. This paper will provide an introduction to opportunities in international real estate, and will show that international real estate holdings can complement a North American real estate allocation, as well as a globally diversified portfolio of stocks and bonds.

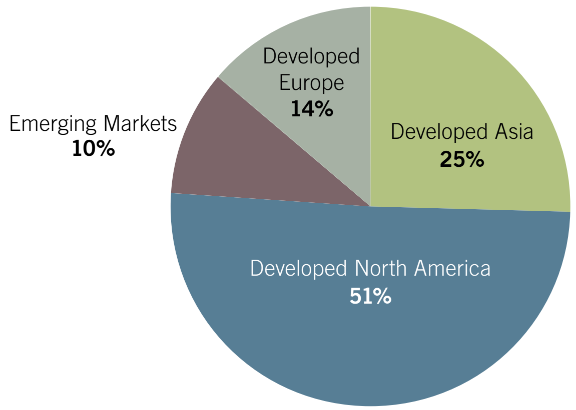
A global opportunity set

As the saying goes, what matters in real estate is "location, location, location." Often the specific street or city area where a real estate company owns property can be a key driver of its fundamentals. Globally, the same is true: Because of different supply-and-demand drivers and market structures, the office market in Tokyo typically has little correlation to market dynamics in New York.

When investing in real estate, most North American investors concentrate on an area close to home. At the end of 2014, the level of assets in U.S.-domiciled mutual funds and exchange-traded funds (ETFs) focused on U.S. real estate was nine times that of funds focused on international real estate.[2] Yet North America represents only half the global real estate opportunity set, with roughly 51% of global market capitalization as of year-end 2014, a historical peak (see Exhibit 1, below).

EXHIBIT 1: International represents roughly half of global real estate securities market capitalization.

GLOBAL REAL ESTATE COMPOSITION BY MARKET CAPITALIZATION



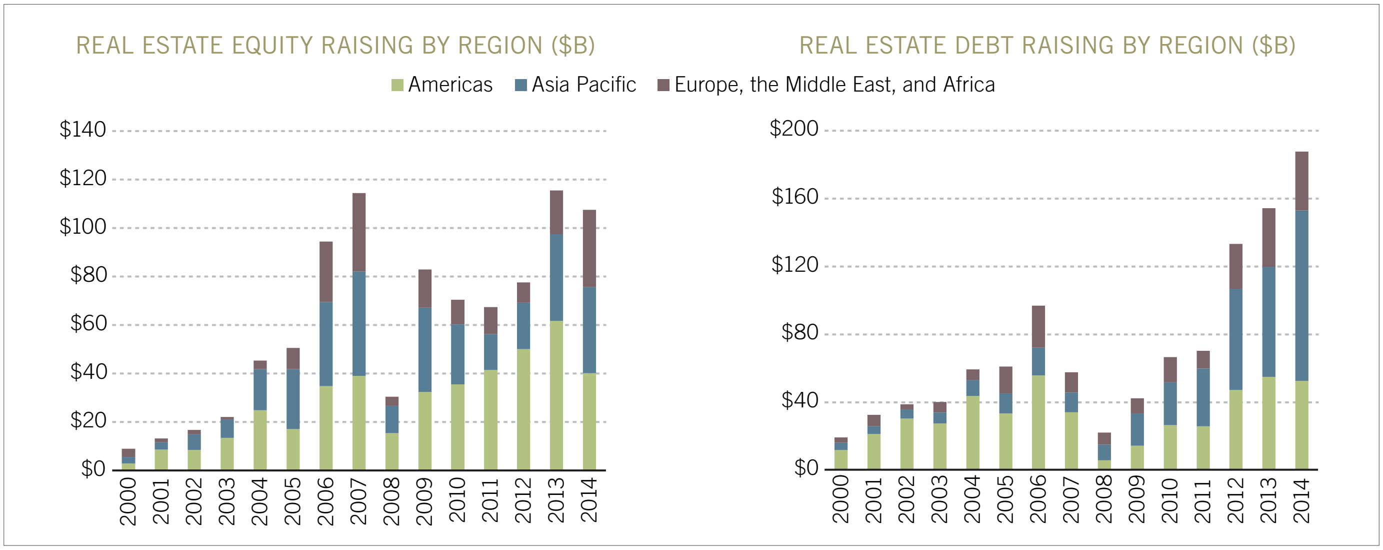
The total for Developed North America represents about 48% U.S. and 3% Canada. The international real estate universe is represented by the FTSE EPRA/NAREIT Developed ex-North America Index. Source: European Public Real Estate Association (EPRA) Monthly Statistical Bulletin, as of Dec. 31, 2014.

KEY TAKEAWAYS

- International real estate makes up a significant portion of the global real estate opportunity set, and deserves consideration by investors wishing to allocate to the real estate asset class.
- International real estate has many distinguishing features that can make it a useful complement to a North American real estate allocation, to international stocks and bonds, and to a globally diversified portfolio.
- International real estate offers investors the potential to benefit from long-term growth trends, such as the development of property types that are prevalent in North America but still emerging elsewhere.

Fidelity INVESTMENTS

EXHIBIT 2: International real estate has made up a large portion of global equity and debt issuance.



Source: Dealogic, as of Dec. 31, 2014.

If we consider the total value of real estate globally, not just that reflected by listed securities, North America represents only 30% of this broader universe. International regions also have represented a significant portion of total global real estate capital raising in recent years (see Exhibit 2, above).

Maintaining a home-country bias may obscure the potential benefits that international real estate can offer, including diversifying an allocation to North American real estate, diversifying a global stock-and-bond portfolio, and taking advantage of long-term real estate growth opportunities abroad.

Potential benefits of international real estate

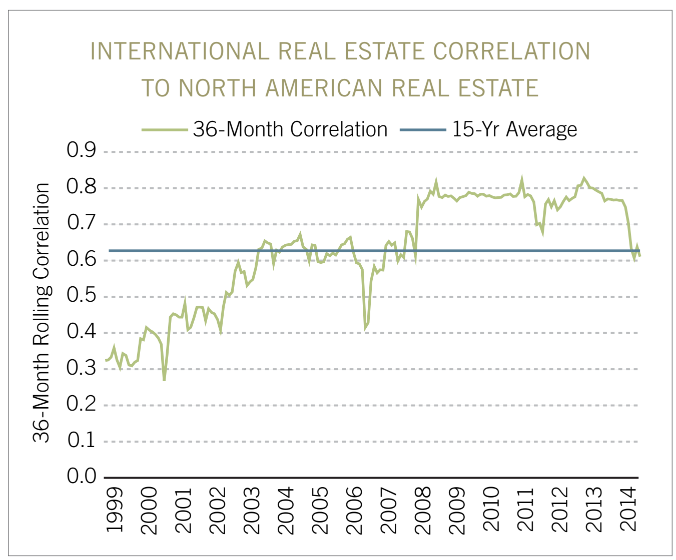
Diversifying an allocation to North American real estate

Individual property sectors can behave differently from one country to another, as varying economic and local market conditions affect supply and demand. Different lease structures, often due to local customs, also can have an effect; for example, office leases are traditionally two years in Japan, three years in Hong Kong and Singapore, five to 10 years in the U.S., and 10 or more years in the U.K.

Investing across geographic areas can help diversify a real estate portfolio, theoretically leading to lower volatility and potentially greater risk-adjusted returns. In general, international real estate has demonstrated imperfect correlation relative to North American real estate over time (see Exhibit 3, right). Performance differentiation also has been relatively high, with returns on international real estate differing from those on North American real estate by 20 percentage points or more on multiple occasions during the past 15 years (see Exhibit 4, page 3). Lower correlation and high performance differentiation can make international real estate a useful complement to a North American real estate portfolio.

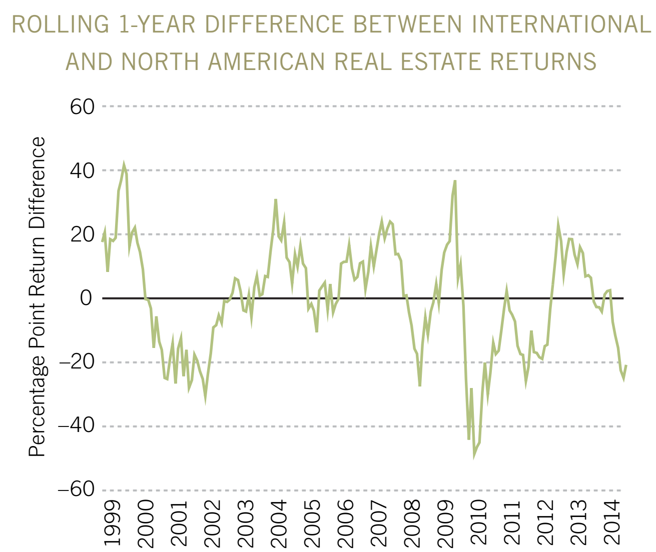
It's worth noting that few real estate companies operate on a global basis, in contrast to other types of companies that may sell into global markets and thus gain exposure to global supply-and-demand factors. For example, 46% of the sales for S&P 500® Index companies come from outside the United States.[3] This means an investor using a strategy that closely tracks the S&P

EXHIBIT 3: International real estate has demonstrated imperfect correlation to North American real estate.



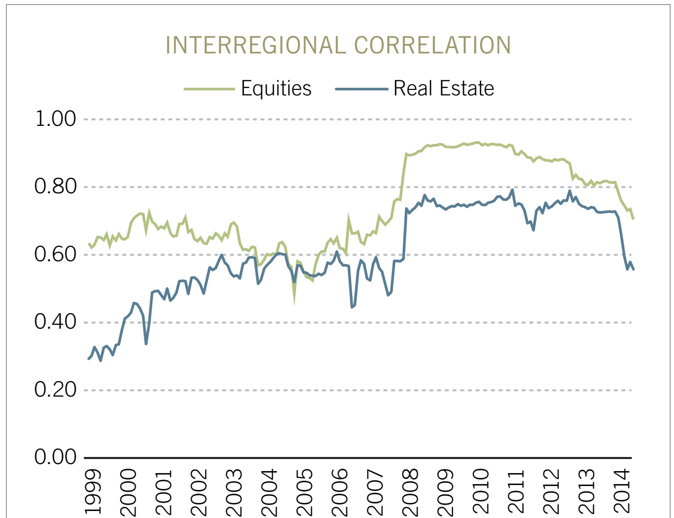
The international real estate universe is represented by the FTSE EPRA/NAREIT Developed ex-North America Index. North American real estate is represented by the FTSE EPRA/NAREIT North America Index. Correlation measures the interdependencies of two random variables, reflecting perfect negative correlation at –1, absence of correlation at 0, and perfect positive correlation at +1. Source: FactSet, as of Dec. 31, 2014.

EXHIBIT 4: The difference between international and North American real estate returns has been significant.



The international real estate universe is represented by the FTSE EPRA/NAREIT Developed ex-North America Index. North American real estate is represented by the FTSE EPRA/NAREIT North America Index. Source: FactSet, as of Dec. 31, 2014.

EXHIBIT 5: Interregional correlation has been lower for real estate than for broader equities.



Average of 36-month correlation between North America, developed Europe, and developed Asia. Regional equities markets are represented by the MSCI North America Index, MSCI Europe Index, and MSCI Pacific Index. Regional real estate is represented by the FTSE EPRA/NAREIT North America Index, FTSE EPRA/NAREIT Developed Europe Index, and FTSE EPRA/NAREIT Developed Asia Index. Source: FactSet, as of Dec. 31, 2014.

500 Index would be getting a fair amount of international diversification through international revenue exposure of the underlying companies. However, only about 3% of U.S. real estate company revenues come from overseas,[4] meaning an investor in U.S. or North American real estate securities is getting almost no international exposure. This further highlights the merits of a dedicated international allocation in real estate.

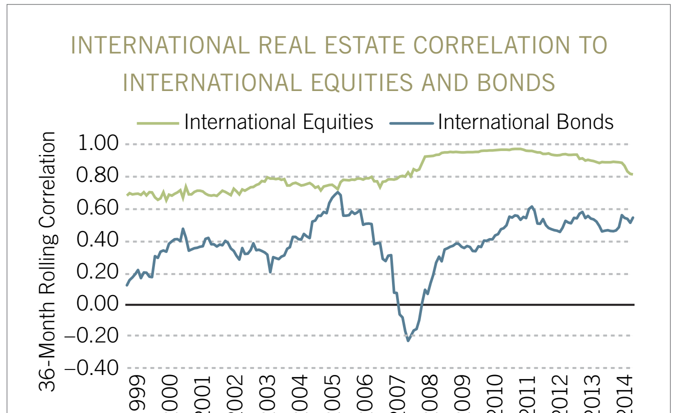
Diversifying a global stock-and-bond portfolio

As a result of local supply/demand drivers and different market structures, interregional correlation for real estate is generally lower than that for broader equity markets (see Exhibit 5, above right). International real estate also has demonstrated imperfect correlation to international equities and relatively low correlation to international bonds (see Exhibit 6, right). Correlation rose after the financial crisis in 2008, as investors focused on an increasingly narrow number of factors—such as central bank policy—but it has since declined, with a wider range of fundamental considerations driving prices.

Imperfect correlation can help to diversify a global stock-and-bond portfolio. In Exhibit 7 (page 4), we show the correlation during the past 15 years between international real estate and a hypothetical global balanced portfolio composed of 60% stocks and 40% bonds.

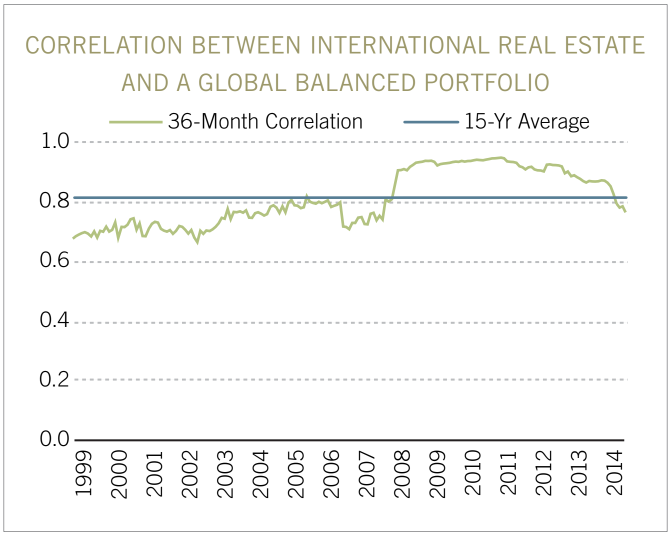
Investment in real estate is sometimes compared to investment in bonds, given the income characteristics and relatively steady cash flow potential of real estate. However, real estate securities differ from bonds in several key ways. For one, they are less sensitive to inflation than fixed-rate bonds, because real estate companies have the potential to increase cash flows and distributions by raising rents. Additionally, real estate asset values have the potential to increase over time, in tandem with inflation and through efficient management of properties.

EXHIBIT 6: International real estate has demonstrated imperfect correlation to international equities and bonds.



The international real estate universe is represented by the FTSE EPRA/NAREIT Developed ex-North America Index. International equities are represented by the MSCI EAFE Index, and international bonds by the J.P. Morgan Government Bond Indices (GBI) Global ex-United States Index. Source: FactSet, as of Dec. 31, 2014.

EXHIBIT 7: International real estate can help to diversify a global balanced portfolio.



The international real estate universe is represented by the FTSE EPRA/NAREIT Developed ex-North America index. The global balanced portfolio is represented by a hypothetical blended index that combines the total returns of the MSCI World Index (60%) and the Citigroup World Government Bond Index (40%). Source: FactSet, Fidelity Investments, as of Dec. 31, 2014.

Benefiting from secular growth opportunities

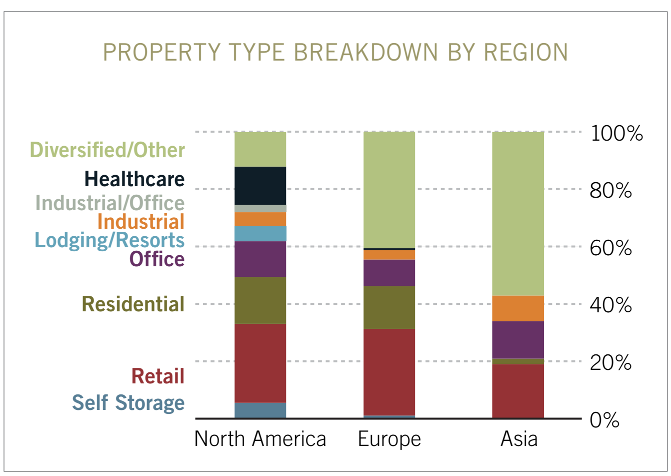
In addition to the diversification benefits offered by international real estate, this segment of the real estate market also may offer compelling secular, or long-term, growth opportunities. Real estate trends tend to start in North America, which includes a much wider range of property types (see Exhibit 8, below), and then spread to Europe and Asia.

For example, niche real estate sectors such as self-storage and health care are well established and widely followed in North America, but only beginning to develop in Europe and Asia. As reflected in Exhibit 8, self-storage represents approximately 6% of the North American market, but has only minimal exposure in Europe and Asia. The largest U.S. self-storage company has a market capitalization in excess of $30 billion, while the market cap for similar companies in Europe and Australia is still below $2 billion.[5] Meanwhile, there is generally limited penetration of this property type in foreign markets (see Exhibit 9, below). These factors suggest there could be an opportunity for a major self-storage company to emerge outside North America.

The development of listed health care properties is another potential area of opportunity. Health care represents 13% of the North America market, but again is an area of limited exposure in Europe and Asia. In Asia in particular, the development of this sector is supported by strong secular tailwinds, such as an aging population and rising incomes, which are driving increased demand for quality health care and senior living facilities.

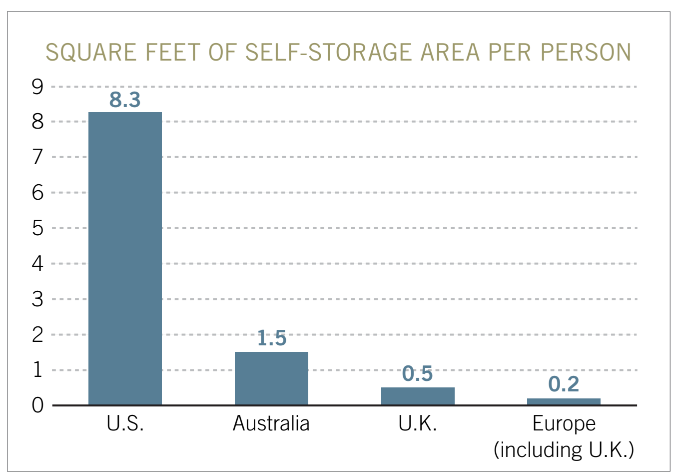
Another consideration is that the natural development of the property sector in Asia provides opportunity for earnings growth as properties transition to professional real estate management teams, which can help to increase the utilization and yield of a given real estate asset. Many owners outside North America have been incentivized primarily to increase assets under management. However, investor demand for better-run companies and compensation incentives that are more aligned with investor goals may spur a transition to returns-based compensation, a potential driver to further unlock value. Additionally, there is opportunity for corporate governance policies to improve, bringing them more in line with those common in North America.

EXHIBIT 8: Certain property types are well established in North America, but underrepresented in Europe and Asia.



The North American market is represented by the FTSE EPRA/NAREIT North America Index, Europe by the FTSE/EPRA Developed Europe Index, and Asia by the FTSE/EPRA Developed Asia Index. Source: EPRA Monthly Statistical Bulletin, as of Dec. 31, 2014.

EXHIBIT 9: Key markets outside North America show significant underpenetration of self-storage facilities.



Source: Big Yellow Group PLC (U.S. market from 2015 Self-Storage Almanac published by MiniCo, U.K. market from 2014 SSA UK & Deloitte Real Estate, European market from 2014 Fedessa Report), Fidelity Investments, as of Dec. 31, 2014.

Key market differences

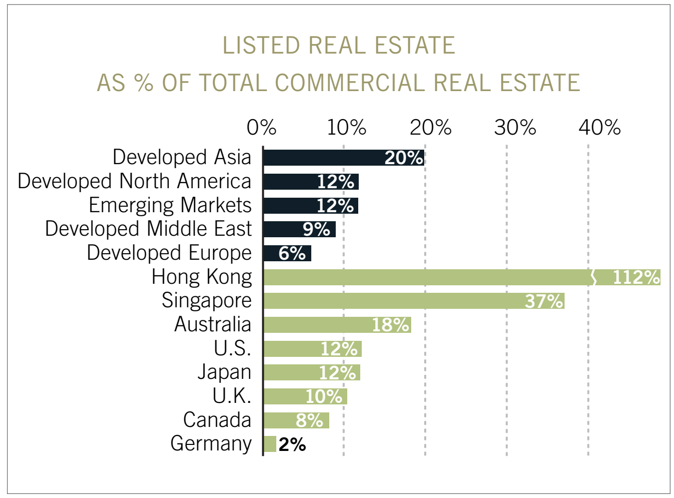
For many investors, listed securities may be the only real option for global real estate diversification. Investing directly in commercial properties—such as buying an apartment building or shopping mall—is time-consuming and requires significant capital. This is one of the advantages of listed property companies: In purchasing even a single share, investors are able to gain diversified commercial property exposure with much lower capital requirements. Also, as difficult as direct property investment can be in one's home country, it can be even more difficult abroad. Not only does direct investing abroad introduce geographic challenges, but many countries place limitations on property investment by foreigners. Hong Kong, Switzerland, and Japan are a few such examples.

There are some key differences worth noting between listed international real estate companies and their North American counterparts, including:

- **Management structures:** North American real estate companies (of which the U.S. makes up a significant portion) tend to be primarily organized with internal management teams, whereas external management—in which the asset management function is outsourced—is a more prevalent structure internationally, and indeed is a requirement for real estate investment trusts (REITs) in some countries.

- **REIT adoption:** Within North America, most companies have adopted REIT status, and can engage in a range of real estate investment and development activities. Outside North America, there is more distinction between companies that invest in and develop real estate and passive REITs. One of the reasons for this is that some countries, such as Japan, restrict REITs from property development. The listed real estate sector in North America is almost exclusively made up of REITs (99%), while REITs represent a much smaller portion in Asia (50%) and Europe (63%).[6] REIT restrictions on management structures and property development in some countries are some of the most notable drivers of this difference.

EXHIBIT 10: Listed real estate as a portion of total commercial real estate varies widely by region and country.



Hong Kong– and Singapore-listed real estate includes securities of companies focused on real estate located in mainland China. Source: EPRA Monthly Statistical Bulletin, as of Dec. 31, 2014.

- **Listed real estate levels:** The portion of commercial real estate owned by listed companies varies significantly across regions and countries. In North America, listed real estate securities account for approximately 12% of the total value of commercial real estate properties (see Exhibit 10, above). In Europe, ownership is lower than in North America, while in Asia it is higher, driven particularly by mainland China–focused companies listed in Hong Kong and Singapore.

- **REIT structure:** The first REIT structure was enacted in the United States in 1960, to make income-producing real estate investments more accessible to individual investors. Today, more than 30 countries offer some sort of tax-advantaged structure for real estate companies, although they differ in various ways (see Exhibit 11, below, which highlights some of the primary REIT structures around the world).

EXHIBIT 11: Major REIT structures around the world.

	U.S.	Canada	Japan	Hong Kong	Australia	U.K.	France
Year Enacted	1960	1994	2000	2003	1985	2007	2003
Management	Primarily internal	Internal or external	External mandated	Majority external	Internal or external	Primarily internal	Primarily internal
Development	Allowed	Allowed	Prohibited	Allowed	Allowed	Allowed	Allowed
Leverage Restrictions	None	None	May receive loans only from qualified institutional investors	Limited to 45% of total gross asset value	None; however limits on deduction of interest	Interest cover test	Limits on deduction of interest
Real Estate Investments	REITs must generally invest a significant portion of assets in real estate. Specifics vary by country.						
Payout Requirements	REITs must generally distribute majority of income. Specifics vary by country.						

Source: EPRA, Fidelity Investments, as of 2014. The information in this table has been simplified and is for illustrative purposes only.

Additional considerations

International real estate does introduce foreign currency exposure to investors who might otherwise invest solely in their home country. Currency can play an important role in investment diversification. Currency can be volatile over shorter time periods, boosting returns relative to an investor's base currency in some periods, while detracting in other periods. However, over longer periods, these currency movements are likely to mean revert.

Investors may want to take into consideration the relative liquidity of international real estate securities compared with their North American counterparts. While greater liquidity is a key benefit of listed real estate versus direct ownership, trading volumes for listed securities are generally higher in North America than internationally. However, the liquidity of the international markets has improved over time, in conjunction with the development of the sector and the increase in total market capitalization.

Some investors also have expressed concern about rising interest rates, particularly in the United States, and the impact this could have on real estate securities. While real estate is a capital-intensive business, and higher interest rates can make capital more expensive, there are many reasons why higher interest rates should also be positive for real estate. Higher interest rates are generally associated with an improving economy, which is positive for real estate demand and can be expected to contribute to higher occupancy levels and rental growth, as well as higher transaction prices paid for properties. During the past 15 years, the correlation between U.S. interest rates and international real estate performance has averaged slightly above zero (0.06), periodically alternating between positive and negative correlation.[7]

Asset allocation implications

International real estate represents a significant component of the global real estate opportunity set. This important real estate segment offers unique features and fundamental diversification driven by local supply/demand dynamics that can make it a useful complement to a North American real estate allocation and to a global stock-and-bond portfolio.

Investors seeking to access the benefits of international real estate can do so through a dedicated international strategy (i.e., focusing only on exposure outside the investor's home country) or through a global strategy that invests in real estate across regions. If using an international strategy, investors could use market cap as a guide in deciding how much to allocate to international, and then adjust to fit their personal or institutional risk-and-return objectives.

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Past performance is no guarantee of future results.

Investing involves risk, including risk of loss.

A REIT issues securities that trade like stocks on the major exchanges, and invests in real estate directly, either through properties or mortgages. A REIT is required to invest at least 75% of total assets in real estate and to distribute 90% of its taxable income to investors. Illiquidity is an inherent risk associated with investing in real estate and REITs. There is no guarantee the issuer of a REIT will maintain the secondary market for its shares, and redemptions may be at a price that is more or less than the original price paid. Changes in real estate values as well as economic downturns can have a significant negative effect on issuers in the real estate industry.

All indexes are unmanaged. You cannot invest directly in an index.

Stock markets are volatile and can decline significantly in response to adverse issuer, political, regulatory, market, or economic developments.

Because of its narrow focus, sector investing tends to be more volatile than investments that diversify across many sectors and companies. Sector investing is also subject to the additional risks associated with its particular industry.

In general the bond market is volatile, and fixed income securities carry interest-rate risk. As interest rates rise, bond prices usually fall, and vice versa. This effect is usually more pronounced for longer-term securities.

Fixed income securities also carry inflation risk, liquidity risk, call risk, and credit and default risks for both issuers and counterparties. Any fixed income security sold or redeemed prior to maturity may be subject to loss.

Endnotes

[1] Source: The National Association of Real Estate Investment Trusts.®

[2] Based on assets totaling $141 billion in U.S.-focused real estate funds, and $15 billion in international-focused real estate funds. Source: Morningstar, Fidelity Investments, as of Dec. 31, 2014.

[3] Source: S&P Dow Jones Indices, "S&P 500® 2013: Global Sales Year in Review," Sep. 2014.

[4] Source: Fidelity Investments.

[5] Based on market capitalization (in U.S. dollars) of publicly traded companies Public Storage ($32 billion), Big Yellow Group Plc ($1.5 billion), Safestore Holdings Plc ($749 million), and National Storage REIT ($351 million). Source: FactSet, as of Dec. 31, 2014.

[6] Based on an analysis of real estate markets as represented by the following indexes: FTSE EPRA/NAREIT North America REITs; FTSE EPRA/NAREIT North America Non-REITs; FTSE EPRA/NAREIT Developed Asia REITs; FTSE EPRA/NAREIT Developed Asia Non-REITs; FTSE EPRA/NAREIT Developed Europe REITS; and FTSE EPRA/NAREIT Developed Europe Non-REITS. Source: FactSet, as of Dec. 31, 2014.

[7] Based on 36-month rolling correlation between the U.S. Treasury 10-year bond yield and the FTSE EPRA/NAREIT Developed ex-North America index. Source: FactSet, as of Dec. 31, 2014.

Definitions

The European Public Real Estate Association (EPRA) is a common interest group that aims to promote, develop, and represent the European public real estate sector.

The National Association of Real Estate Investment Trusts (NAREIT) is a trade association for REITs and publicly traded real estate companies with an interest in the U.S. property and investment markets.

Index definitions

The Citigroup World Government Bond Index is a market-value-weighted index of investment-grade debt issues traded in world government bond markets.

The FTSE EPRA/NAREIT Developed Asia Index is a subset of the FTSE EPRA/NAREIT Developed Index that incorporates real estate investment trusts (REITs) and real estate holding and development companies. The FTSE EPRA/NAREIT Developed Europe Index is a subset of the FTSE EPRA/NAREIT Developed Index that incorporates real estate investment trusts (REITs) and real estate holding and development companies. The FTSE EPRA/NAREIT Developed ex-North America Index is a market-capitalization-weighted index of all eligible developed market real estate stocks worldwide, excluding North America. The FTSE EPRA/NAREIT Developed REITs and Non-REITs Indices are a subset of the FTSE EPRA/NAREIT Developed Index, separating the existing constituents into both REITs and non-REITs indices. The FTSE EPRA/NAREIT Emerging Index is designed to track the performance of listed real estate companies and REITS in emerging markets. The FTSE EPRA/NAREIT North America Index is designed to track the performance of listed real estate companies and REITS in North American markets (U.S. and Canada).

The JPMorgan Government Bond Indices (GBI) Global ex-U.S. Index is an unmanaged index representative of the total return performance in U.S. dollars of major non-U.S. bond markets.

The MSCI EAFE Index is a market-capitalization-weighted index that is designed to measure the investable equity market performance for global investors in developed markets, excluding the U.S. & Canada. The MSCI Europe Index is a market-capitalization-weighted index that is designed to measure large- and mid-cap market performance across 15 developed-market countries (Austria, Belgium, Denmark, Finland, France, Germany, Ireland, Italy, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, and the U.K.) in Europe. The MSCI North America Index is a market-capitalization-weighted index designed to measure the performance of the large- and mid-cap segments of the U.S. and Canada markets. The MSCI Pacific Index is a market-capitalization-weighted index designed to measure large- and mid-cap market performance across five developed-market countries (Australia, Hong Kong, Japan, New Zealand, and Singapore) in the Pacific region. The MSCI World Index is a market-capitalization-weighted index that is designed to measure the investable equity market performance for global investors of developed markets.

The S&P 500® Index is a market-capitalization-weighted index of 500 common stocks chosen for market size, liquidity, and industry group representation to represent U.S. equity performance. S&P 500 is a registered service mark of Standard & Poor's Financial Services LLC.

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