OAK INVESTMENT MANAGEMENT GROUP

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On a single real estate asset, a rational investor will seek as much return as possible for a given set of riskiness that the he or she is willing to tolerate. The aim of portfolio theory in real estate is to maximise the return whilst minimising the risk through diversified ownership of real estate assets. This can be achieved in various ways – but, in practice, clarity of thinking is required in order not to needlessly give up return with no commensurate decrease in risk profile.

Diversification in real estate can be attained in relation to the property itself (location and type), in relation to the income that derives from it (lease and covenant) or in relation to the timing of commitments, coupon payments and sales that can be realised from it. In the first instance, different sub-sectors, locations, quality of buildings, durability of buildings all play a role. In the second instance, different numbers of tenants, duration of leases, type of leases, 'quality' of leases all are relevant. In the last instance, timing of execution and judgement of economic cycles are all key factors.

The enemy of diversification in real estate, as with all other asset classes, is the cost of borrowing. Capital will try and reflect the perceived riskiness of each property or income profile by demanding a greater or lower spread on a facility provided. This will have the effect of marginalising the benefits of diversification between real estate holdings or within a portfolio.

However, this does not mean that diversification is pointless, that the 'efficient frontier' should not be sought or that 'alpha' does not exist in selecting and owning real estate. From a macro point of view the value in having different exposure to sub-sectors is that they are all driven by different needs / different cycles. Uncorrelated characteristics ultimately mean a greater degree of safety of the equity participation or for fundamental projected cash flow. From a micro point of view correct selection within sub-sectors can mean more resilient or robust performance in down times and better performance in up times. This also means that equity participation is better compensated for the risk that it incurs.

Because of the numerous variables involved in selecting, investing, holding and disposing of diversified real estate exposure it is essential that there is a proper investment thesis, ongoing monitoring as well as managed 'sell downs' of real estate. There are many false diversifications, such as geographical which can often prove to be illusory. There are also many historical diversifications that actually post-commitment prove to be correlated. Usually this is predicated on many market participants acting in synchronisation and with the same assessment.

Thus there are two important pillars of correct diversification. The first pillar is to invest in a collection of real estate that mutually reinforces the liquidity for debt / equity payments (*cash flow value*). The second pillar is to read the rest of the market so that the real estate asset is marketable within the set time horizon (*capital value*). A diversified real estate holding should hold its own for cash flow value and capital value throughout the life of the investment period.

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