REAL ESTATE

Shifting Institutional Property Portfolios: Evolution or Revolution?

INSIGHTS

From shifting demographics to the adoption of new innovations, long-term societal changes provide strong clues to how institutional property portfolios will likely restructure over the next decade.

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Investment Decision-making Reflects Societal Change

The composition of institutional investors' property portfolios has dramatically changed over the past few decades. This is a reflection of wider societal shifts, given that the property industry plays a key role in accommodating changes to how we live, work and play.

In particular, long-term social changes including shifting demographics, the adoption of new innovations and the emergence of societal trends such as ESG all have a major influence on investors' objectives—and in turn potential investment outcomes. Specifically, the three key objectives shared by most investors are:

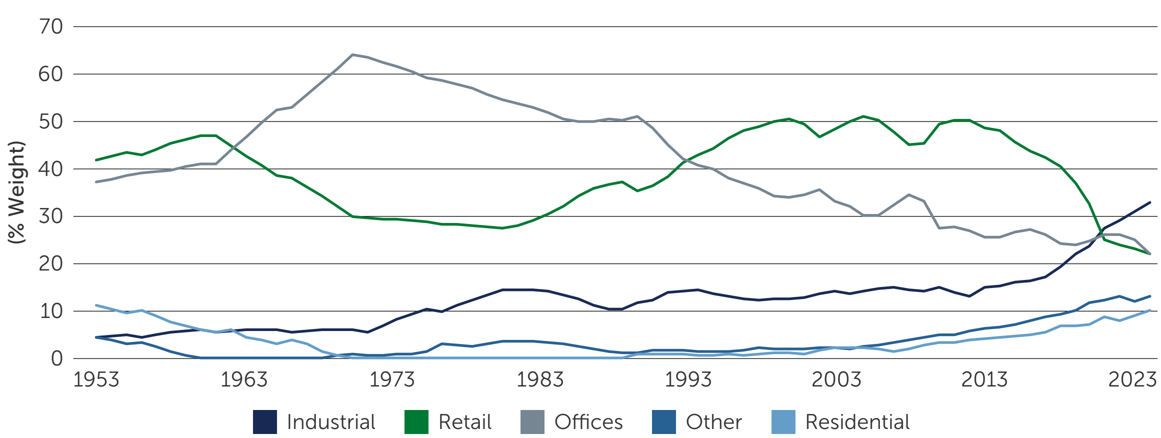
- Expand the investment universe (as dictated by the supply of suitable investments).
- Seek enhanced returns (whether by total, income, capital, or risk-adjusted returns).
- Reduce portfolio risk (by increasing diversification).

Evolution or Revolution?

It's widely perceived that the composition of property portfolios is currently undergoing unprecedented change. While it is true that the range of investable asset types and property sectors is wider than ever, the data suggests an ongoing evolution, rather than a revolution.

In the U.K. property market for example—where the data is robust and covers a long-term period—like many other developed economies, a shift toward the service sector from the 1960s to 1990s occurred with a corresponding rapid acceleration in finance, business administration and professional jobs. The office sector typically accounted for 50–60% of investment portfolios back then **(Figure 1)**. The corresponding de-industrialization of the U.K. economy over the same period is not reflected in property portfolios because these specialized and bespoke industrial plants were owner-occupier, not leasable and therefore never part of the investable institutional property universe.

Figure 1: Shifting Composition of U.K. Property Portfolios



Source: Jones 2013. MSCI 2024.

Similarly, the rise of the retail sector to dominate portfolios through the 1980s and 1990s coincided with the baby-boomer demographic reaching adulthood, as well as an expansion of mass consumerism, which was partly enabled by the increased adoption of innovations in household finances (i.e. unsecured household credit and mortgage equity release). For an extended 20-year period, retail property offered a compelling combination of consistently higher returns and lower risk.[1] This period was also the heyday of the shopping center and retail park development boom, thus adding a structural supply angle given the potential for a significant expansion in the investment universe.

"Changing demographics, endemic housing shortfalls and a rising propensity to rent have been driving the rise of the multifamily property sector as a credible institutional asset class."

More recently, changes to property sector selections reflect the e-commerce-driven fall of retail from its dominant position to around 20% of U.K. portfolios today. Going forward, retail allocations will likely focus on grocery, neighborhood/convenience, open-air retail warehouse/power-centers, and similar asset types, reflecting the resilience of food, DIY/hardware and gardening retail segments to online competition. The flip side of the e-commerce impact has been the doubling of industrial allocations, big box, urban/final mile logistics and multi-let estates, which now account for over 30% of current U.K. portfolios. This technology-driven trade-off will likely play out at a varying pace across property markets around the world, in line with how their adoption of online shopping evolves.

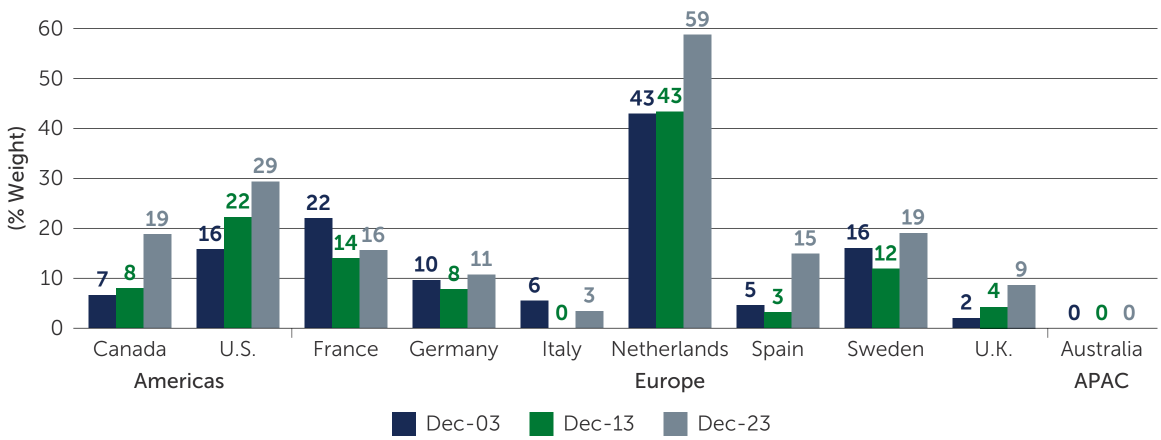
Residential: The Exception to Prove the Rule

Changing demographics, endemic housing shortfalls and a rising propensity to rent have been driving the rise of the multifamily property sector as a credible institutional asset class. The expansion of professional investment into residential assets is an entrenched investment trend in the U.S., dating from the early to mid-1980s and driving institutional exposure from near nil up to around 30% today.[2] This has been supported by structural trends in the U.S., including the need for higher U.S. workforce mobility across a single enormous but poly-centric economy, as well as by demographic factors such as smaller household numbers resulting from a rising divorce rate and delayed births/family formation.

1. Source: MSCI U.K. Annual Property Index. As of April 2024.
2. Source: NCREIF Property Index (NPI). As of June 2024.

Over the past decade, the trend toward residential investment has also been building across most key European property markets, particularly Spain, Sweden and the U.K. **(Figure 2)**. While the residential sector remains nascent in Australia property portfolios, intense housing shortages and affordability concerns mean institutional interest in build-to-rent (BTR) is expected to accelerate in the near term.

Figure 2: Global Residential Property Index Weights



Source: MSCI. As of July 2024.

While the rest of the world appears to lag U.S. residential institutional investment, the Netherlands has been an exception. This is a relatively small, very densely populated and wealthy economy with a heavy surplus of savings over investment assets. For this reason, despite heavy rent regulation and very generous mortgage interest income tax relief, residential assets have accounted for over half of the Dutch property benchmark since inception.

Given the well-documented housing shortages across most of the world, and with the total global housing asset base dwarfing the value of global equity and bond markets combined[3], the residential sector offers investors enhanced return prospects and the potential for investment universe expansion. We therefore expect residential investment to dominate future property allocations in most key markets by the end of the next decade.

The Ascent of "Others"

The past decade has also seen the rise of the "others" property segment of the market, which has grown in both the U.K. and U.S. from low single-digit weights to over 10% of typical portfolios.[4] However, while aggregated as one segment, "others" actually comprises a plethora of distinct and hybrid property types, ranging from data centers, healthcare, life science, to student housing, self-storage and beyond. These are small sectors in isolation—hence why they are part of the aggregation—but significant growth potential exists in many of these asset types.

3. Source: "Total Value of Global Real Estate", Savills. As of September 2023.
4. Source: MSCI U.K. Annual Property Index. As of April 2024; NCREIF Property Index (NPI). As of June 2024.

Investing in the "others" property sectors offers investors the potential for risk reduction via diversification, and the opportunity to align with different and emerging economic growth drivers. This could mean tapping into the exponential computational data needs for A.I. adoption via data centers, or capitalizing on the increased need for self-storage as housing shortages and affordability concerns drive residential unit sizes smaller. And given the ageing population, it could also offer the opportunity to increase exposure to the growth in future demand for senior and healthcare properties. While many of these asset types may mean more operational cashflow risks, operational income is often higher returning, and the power of diversification could potentially enhance risk-adjusted returns at the overall portfolio level.

Strategic Implications

Current societal shifts provide strong clues to how institutional property portfolios will likely restructure over the next decade. Looking ahead, we anticipate investors will increasingly seek to:

- Expand their investment universe by building and maintaining higher residential and industrial weights to compensate for a much-reduced retail and office opportunity set.
- Generate potentially enhanced returns by focusing on ESG/tech office, core logistics and operational "others" properties.
- Reduce risk by increasing exposure to "others" property sectors. Even higher risk and return operational property sectors offer diversification potential and could boost risk-adjusted returns.

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**As of June 30, 2024*

24-3836742