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BLACKROCK®

European real estate

Balancing risks and opportunities

October 2018

ALT0918E-601288-1911843

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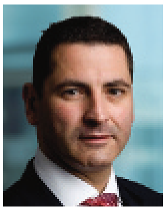

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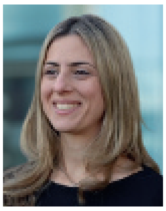

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Summary

- Real estate assets, we believe, can diversify risk within a multi-asset portfolio because their performance is inversely correlated to that of bonds and moderately correlated to that of equities. European real estate can offer a diverse range of exposures to economies at different stages of the growth cycle.

- European real estate has historically provided attractive performance delivering annual compounded returns of 6.9%, over the 17-year period to 2017, outperforming both European equities and bonds, returning 1.9% and 4.4% respectively.[1] Income was the most dominant driver of real estate performance over the long term and displayed significantly less volatility than capital growth.

- Deft market timing and asset selection can further enhance the performance of a real estate portfolio. In addition, real estate can be actively managed to potentially enhance both income and capital returns.

- We see little oversupply in European real estate markets in contrast to the previous cycle. Coupled with growing occupier demand, this has led to historically low vacancy rates in many markets. Rental growth is robust as a result.[2]

- We see a plethora of structural changes such as technological innovation, ageing demographics, urbanisation and sustainability significantly influencing the future performance of real estate. At the same time, cyclical risks are rising: valuations have increased while strong investor interest continues amid a rising interest rates environment and political uncertainty.

- We prefer to focus on relatively liquid and supply-constrained markets in this environment. We favour assets that produce low volatility returns, generate strong cash flows or can be improved by active management.

1 Source: BlackRock with data from Thomson Reuters and EuroStoxx, August 2018. **The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results.** Notes: The analysis is for the period of December 2000 to December 2017, the longest available history for the pan-European real estate index, and is based on annual returns as measured by MSCI pan-European Real Estate index for real estate, Euro Stoxx Gross Return index in euro for European equities and the Barclays Pan-European Aggregate Bond index in euro for bonds. Indexes are unmanaged and performance does not reflect the inclusion of management fees. It is not possible to invest directly in an index.
2 Source: Property Market Analysis (PMA), April 2018.

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The strategic role of European real estate

Real estate can diversify traditional multi-asset portfolios

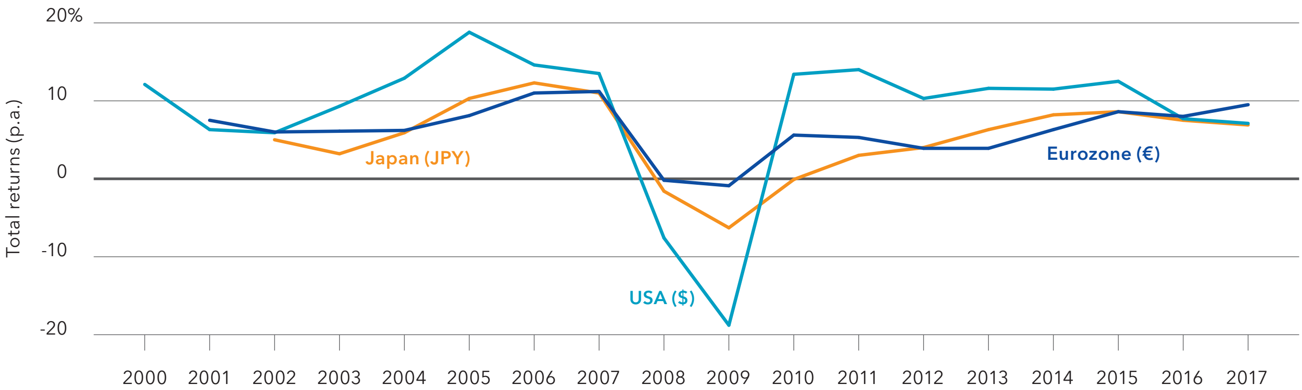
Real estate as an asset class has historically exhibited low to moderate return correlation with other asset classes and therefore, we believe, can provide diversification within a multi-asset portfolio. The performance of European real estate has shown negative correlation (-0.56) with bonds and moderate correlation (0.43) with equities over the 17-year period to 2017.[3] European real estate lies between equities and bonds with its performance exhibiting both equity- and bond-like characteristics.

European real estate can diversify domestic only portfolios, potentially enhancing risk-adjusted returns

Varied correlations between real estate markets means that cross-border portfolios can benefit from diversification effects, potentially improving the risk/return profile over domestic-only portfolios.

Within Europe, cross-border investment provides the opportunity to reduce volatility further. Eurozone real estate returns have been much less volatile when compared with the returns of individual countries, as shown in Figure 1, smoothing out the extreme peaks and troughs experienced within national markets during times of market distress. Economic cycles across European markets tend to move at different speeds and are not usually synchronised. This is in part due to the inability of real estate supply to quickly react to changes in demand. The natural fluctuation between markets offers investors with a pan-European investment strategy the opportunity to time market entry and exit depending on the respective market cycles. Within markets, investors can also diversify across sectors and regions further reducing performance correlations.

Figure 1: Real estate total returns by region/country



Source: MSCI Multinational Digest, Global Index, December 2017. **The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results.** Notes: The specific indexes are: IPD Eurozone Annual Property Index in euro, IPD US Annual Property Index in USD and IPD Japan Annual Property Index in JPY. The indexes measure unlevered annual total returns of directly held standing investments for all property from one valuation to the next. Indexes are unmanaged and performance does not reflect the inclusion of management fees. It is not possible to invest directly in an index.

3 Source: BlackRock with data from Thomson Reuters and EuroStoxx, August 2018. Notes: The analysis is based on annual returns for the period of December 2000 to December 2017, the longest available history for the pan-European real estate index. Performance as measured by MSCI pan European Real Estate index, for real estate, Euro Stoxx Gross Return index for European equities and the Barclays Pan-European Aggregate Bond index for bonds. Indices are unmanaged and performance does not reflect the inclusion of management fees.

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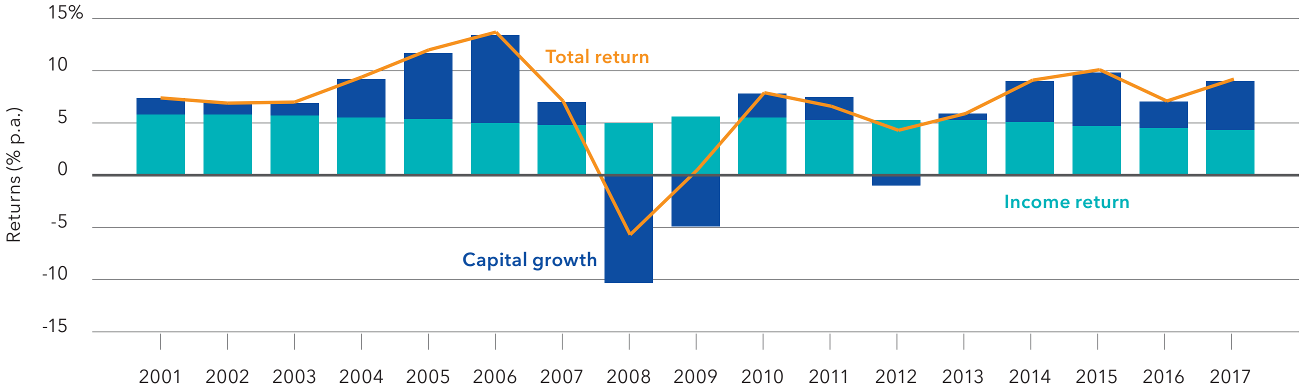
Attractive returns with a high-income component

European real estate has delivered total returns of around 6.9% p.a. over the last 17 years compared with 1.9% and 4.4% p.a. for European equities and bonds respectively (Figure 2). Income was the most dominant driver of real estate performance over this period, as can be seen in Figure 2, providing almost 80% of the total return and exhibiting significantly less volatility than capital growth. However, capturing the capital cycle by correctly timing market entry and exit can further enhance performance.

Figure 2: Pan-European real estate returns



	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Equities % p.a.	-17.1	-33.5	15.0	10.1	26.0	18.3	8.6	-40.8	27.1	-1.3	-15.1	21.5	21.4	5.9	7.6	3.9	11.1
Bonds % p.a.	3.8	6.4	3.7	5.6	3.6	-0.1	2.4	10.2	4.1	2.7	3.9	8.3	1.4	7.6	-0.8	9.6	2.3

Source: BlackRock with data from Thomson Reuters and EuroStoxx, August 2018. **The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results.**
Notes: The analysis is for the period of December 2000 to December 2017, the longest available history for the pan-European real estate index, and is based on annual returns as measured by MSCI pan-European Real Estate index for real estate, Euro Stoxx Gross Return index in euro for European equities and the Barclays Pan-European Aggregate Bond index in euro for bonds. Indexes are unmanaged and performance does not reflect the inclusion of management fees. It is not possible to invest directly in an index.

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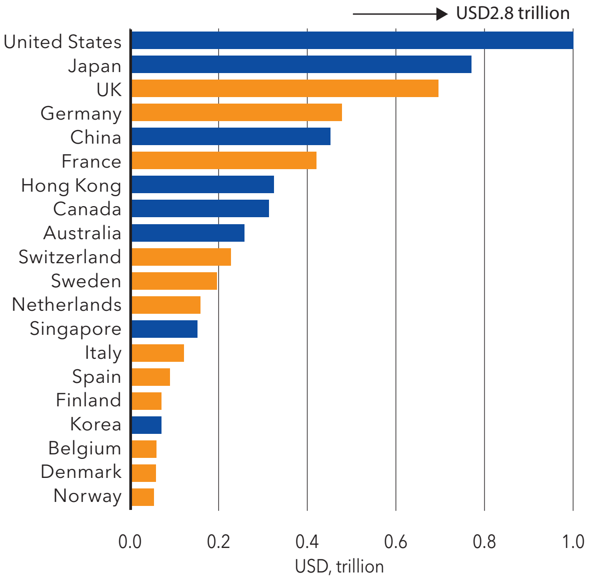
European real estate is a large and diverse market with historically high liquidity and transparency

The size of the professionally managed, invested real estate market in Europe is estimated at USD2.8 trillion and represents around one third of the global universe. The remainder is split almost equally between North America and Asia Pacific.[4] European markets occupy 12 of the top 20 largest invested markets globally as can be seen in Figure 3.

Liquidity is also a feature of many European markets. Capital liquidity scores developed by Real Capital Analytics (RCA) measure property market liquidity by assessing the depth and breadth of investment capital in real estate markets globally. London, Paris and Berlin rank second, fifth and sixth respectively with several other markets like Frankfurt, Munich, Hamburg and Stockholm in the top 30 globally.[5]

European markets also score strongly in terms of transparency. According to the 2018 global real estate transparency index by Jones Lang LaSalle (JLL), the global real estate professional services company, the UK is the most transparent market globally with France, the Netherlands, Germany, Ireland and Sweden all ranking in the top ten most transparent markets.

Figure 3: Size of real estate market by country (USD, trillion)



Source: MSCI Real Estate Market Size, December 2017. Notes: Invested real estate stock is defined as property owned for the primary purpose of benefitting from investment returns, as distinct from owner-occupied and non-investment leased real estate. Analysis in USD.

4 Source: BlackRock, with data from MSCI, December 2017. Notes: Invested real estate stock is defined as property owned for the primary purpose of benefitting from investment returns, as distinct from owner-occupied and non-investment leased real estate. Analysis in USD.
5 Source: Real Capital Analytics (RCA), April 2018. Notes: RCA capital liquidity scores are a measure of property market liquidity which assesses the depth and breadth of investment capital in real estate markets globally and are based on independent reports of properties and portfolios USD10 million and greater.
6 Source: JLL, April 2018. Notes: The index covers 100 markets and is based on 186 indicators. These variables are divided into six areas, performance measurement, market fundamentals, governance of listed vehicles, regulatory and legal frameworks, transaction process and environmental sustainability.

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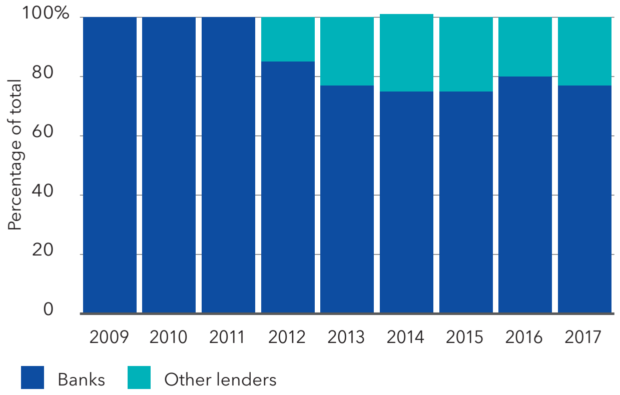
There are a broad range of risk adjusted opportunities

There are various routes to accessing private real estate spanning the risk/return spectrum ranging from private debt to core, value-add and opportunistic strategies. The direct European real estate market has performed strongly over the past ten years, as has the private debt market. However, the European debt market remains relatively opaque compared to the established direct market. Opportunities in the real estate debt market have evolved out of the regulatory change imposed following the global financial crisis (GFC) to mitigate against future bank and sovereign failures. Consequently, alternative lenders have started replacing in part traditional bank lending as seen in Figure 4. The resulting structure of real estate lending has increased the opportunities for investors seeking access to real estate performance whilst closely managing their downside risk in the event of a market downturn or rising interest rate environment.

Figure 4: UK real estate loan origination



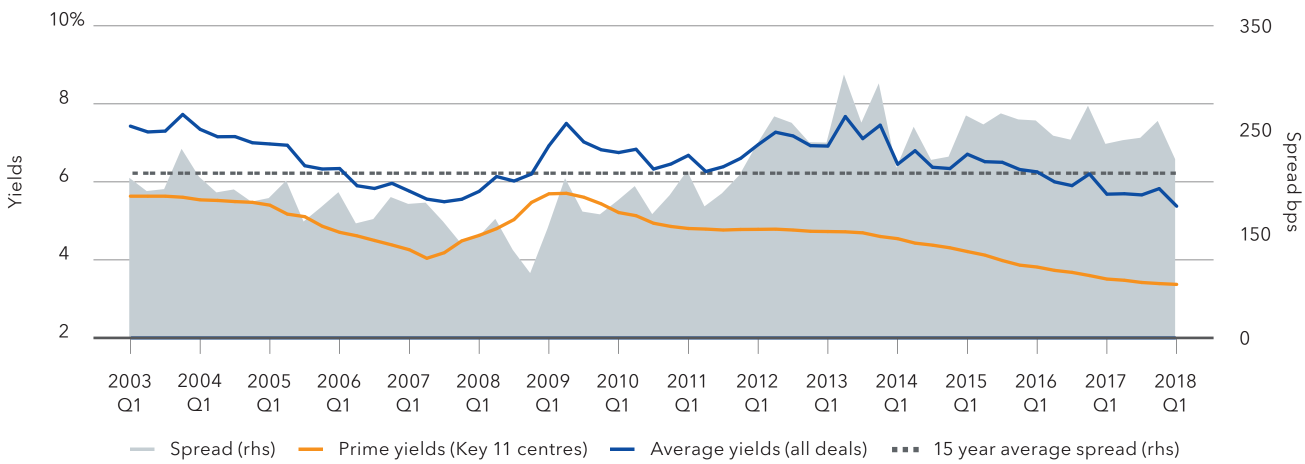
Source: Cass Business School, Commercial Real Estate Lending Survey, April 2018.

Alpha creation opportunities

Real estate assets can be actively managed with the aim to enhance both income and capital returns by focussing on asset level initiatives that can mitigate idiosyncratic risk. This can include improving the quality and purpose of an asset through capital investment and active asset management to enhance the profile and mix of tenants in a multi-let property.

The relationship between prime and average pricing, which can represent a broader and larger pool of assets in a market, is not constant throughout the cycle and as such market selection and timing as well as deal origination are critical to value creation. Figure 5 illustrates prime and average yields for European offices in key markets and the spread between the two. Currently the spread is above its historic average suggesting there is a distinct window for value creation. However, a disciplined approach to market and stock selection is critical to unlocking this potential without excessive risk taking.

Figure 5: European office prime and average yields



Source: BlackRock, with data from PMA, April 2018.

The current context

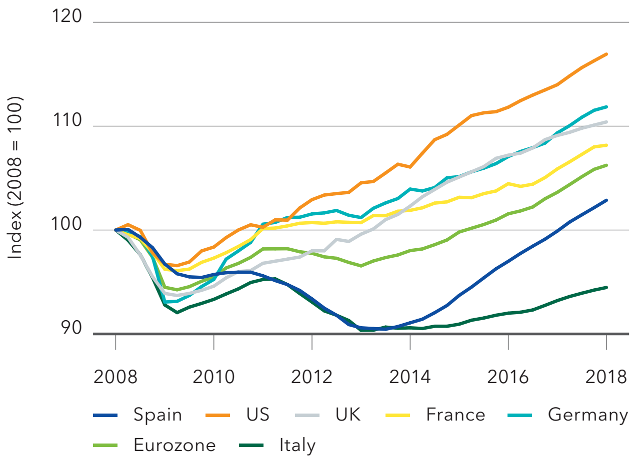
Economic growth momentum and policy divergence

It has taken several years for most economies to return to pre-GFC levels. The US, French and German economies surpassed their pre-crisis 2008 level in 2011 as can been seen in Figure 6. The UK lagged by two years and the southern-tier eurozone countries have been even slower to recover. The recovery in Europe has, therefore, not been synchronised and real estate offers a diverse range of exposures to economies at different stages of the growth cycle.

In more detail, while the economies of Germany, France and the UK have grown by 12%, 8% and 10% respectively since 2008, the economy of Spain has grown by just 3% over the same period having reached its pre-crisis levels only in 2017.[7] Italy remains below its pre-crisis level as its recovery path appears to be more challenged.

Monetary policy is an area of divergence between Europe and the US as shown in Figure 7. The US began normalising interest rates in 2016 following a prolonged period of historically loose policy. The UK has tentatively increased their base rates, however, the European Central Bank (ECB) has explicitly stated that they are likely to keep rates on hold until at least the second half of 2019. This prolonged lower rate environment in Europe can provide some support to asset pricing, including real estate.

Figure 6: GDP growth index since the GFC



Source: BlackRock, with data from Thomson Reuters, August 2018.

Another area of divergence is inflation. Inflation in Europe has been subdued except for the UK while it has been on the rise in the US. The BlackRock Inflation GPS that aims to give a read on the outlook for core inflation in major economies,[8] indicates that inflation rates in Europe are forecast to fall back to levels below the ECB targets while in the US inflation is forecast to remain elevated before levelling off towards the Federal Reserve's 2% target. In the context of real estate, inflation is often compensated for in asset valuations and many European leases also contain an inflationary rental increase component.

7 Source: BlackRock, with data from Thomson Reuters, August 2018.
8 Source: BlackRock Investment Institute. https://www.blackrock.com/institutions/en-us/insights/markets/blackrock-macro-gps

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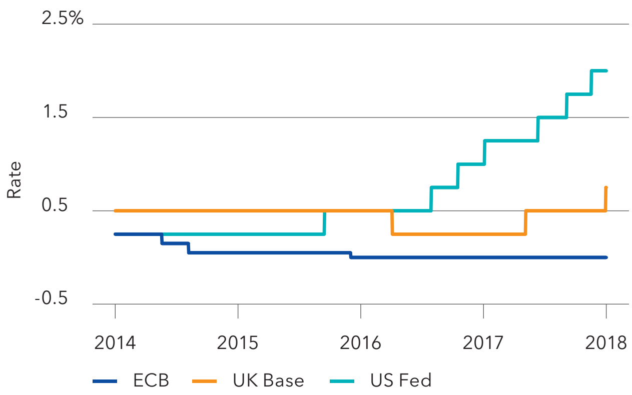
Overall, the economic growth outlook is positive for most major European economies with growth expected to remain robust and broad-based in the medium term with countries that were late to recover catching up.[9] Long-term growth is expected to moderate due to a range of structural influences discussed in the next chapter, including demographic headwinds. However, dynamic cities within Europe are expected to continue to outperform the national average.[10]

Figure 7: Central bank interest rates



Source: BlackRock, with data from Thomson Reuters, August 20180

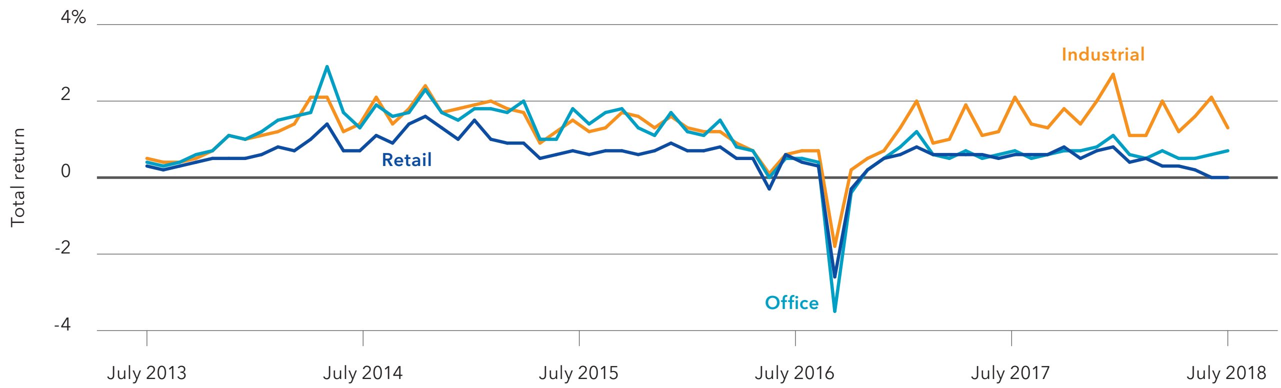
The implications of Brexit

UK real estate has remained resilient in the face of Brexit and continues to attract global capital allocations, particularly in London.[10] The market corrected briefly in the months immediately following the EU referendum but quickly returned to growth as seen in Figure 8.

However, short-term uncertainty is significantly increased in the UK, and to a lesser extent in Europe, due to the ongoing Brexit negotiations. The UK is expected to experience a more severe impact from the final Brexit outcome than the rest of the EU, and Brexit-related uncertainty is expected to negatively impact business investment and stall hiring plans in the short term. It is our view that London will remain Europe's financial capital for the foreseeable future, however, there are signs of relocation activity from London that may not have occurred if the UK had remained in the EU.

Our base case remains that increased pressure for the UK and EU to avoid a no-deal Brexit outcome will result in a compromise later in 2018, with a likely extended transition period beginning in March 2019.

Figure 8: UK total real estate returns (monthly index)



Source: MSCI UK Real Estate Monthly Index, July 2018. **The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results.** Note: MSCI UK Real Estate Monthly Index measures unlevered monthly total returns of directly held standing investments from one valuation to the next, in GBP. Indexes are unmanaged and performance does not reflect the inclusion of management fees. It is not possible to invest directly in an index.

9 Source: BlackRock, with data from Oxford Economics, June 2018.
10 Source: Real Capital Analytics, June 2018. Notes: Referring to cross border capital flows into the UK as reported by European Capital Trends, June 2018.

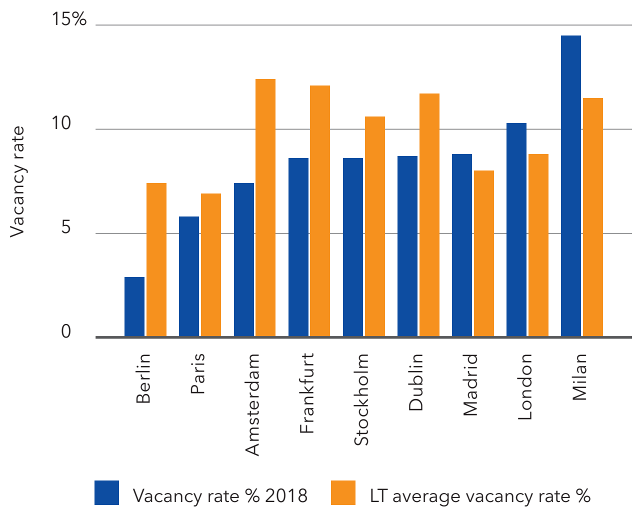
Real estate performance across the cycle

Real estate markets across Europe do not share a synchronised rental growth cycle and the relative supply and demand dynamics drive different responses to changing demand.

In this cycle, markets have not become over supplied as was experienced in the previous cycle, with net additions to stock in most markets remaining below their long-term average.[11] The combination of low levels of new additions to stock and growing occupier demand fuelled by accelerating economic growth has led to historically low vacancy rates in many markets (Figure 9). This has resulted in strong rental growth. As income becomes a more dominant driver of performance going forward, attention on fundamentals increases.

Investors' views on the advancing market cycle manifest in their intentions to invest capital. The 2018 INREV investor intentions survey reported an overriding appetite for European real estate with 67% of investors intending to increase their allocations to the region over the next two years.[12]

Figure 9: Office market vacancy rates

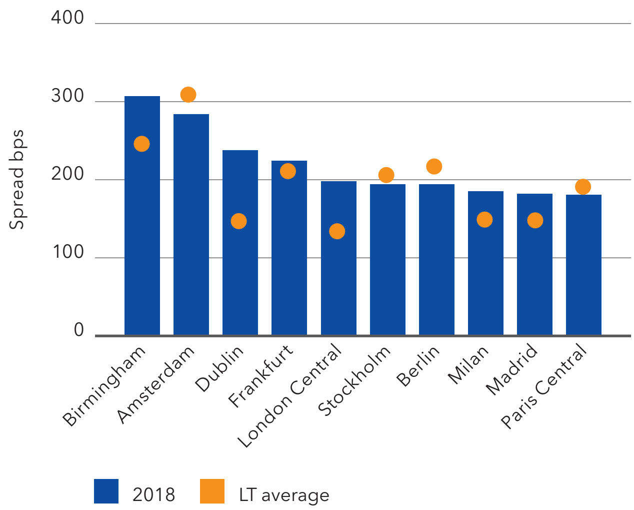


Source: PMA European Office Market Forecasts Summer 2018, June 2018.

Current real estate pricing relative to government bonds indicates that the real estate yield gap for offices is at levels above historical averages in many markets (Figure 10).[13] The opposite is true for European logistics where increased demand from retailers and third-party logistics companies has driven a structural change in demand, reducing the spread to government bonds to historically low levels for the asset class.

Interest rates are an important component of real estate valuations. Furthermore, the debt component of real estate investment provides another transmission mechanism for rising rates to impact real estate activity. Whilst the US and UK have already started raising rates the ECB's forward path is diverging, with rates expected to remain low for longer as discussed earlier.

Figure 10: Office market pricing – prime initial yields spreads to government bonds



Source: PMA European Office Market Forecasts Summer 2018, June 2018.

11 Source: PMA, April 2018.
12 Source: INREV Investor Intentions Survey 2018, April 2018. Notes: Based on a sample of 317: 107 investors, seven fund of funds managers and 203 fund managers; Percentages based only on those invested or intending to invest in each region.
13 Source: PMA European Office Forecasts, April 2018.

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The asset class continues to attract capital seeking a relative safe haven despite prices having been supported by historically low interest rates. Real estate has performed well during previous rising rate cycles and, given recent increases are the result of improving economic fundamentals, this could be repeated.

As European real estate advances through the cycle, a clear bifurcation of performance between markets is evident. Whilst real estate markets are subject to similar external influences each has its own specific supply and demand dynamics that influence investor timing of market entry and exit. For example, the London office market is at a more advanced stage in its cyclical correction to Stockholm which is still approaching its peak. However, views on headline performance should be considered on a risk-adjusted basis as early cycle markets such as Milan and Madrid exhibit a different risk return profile to the more advanced markets of London, Paris and Stockholm.

Long-term drivers of performance

Structural change drives asset opportunities

Whilst real estate performance is driven by the economic cycle it is distorted by a plethora of structural changes due to megatrends that are impacting the way we interact with real estate. Structural change will drive significant performance differences over time as underlying fundamentals become more closely aligned with structural themes. Identifying and understanding these structural shifts is a key component of investment decision-making and can help identify investment opportunities which provide the potential for strong future performance.

To help make sense of the complex interconnectivity of these megatrends we have simplified our thinking along five key themes, summarised in Table 1.

Table 1: Megatrends and potential impact on real estate

Technology	• The catalyst for all other trends and is key to resolving many global issues. • The pace of change is exponential and AI is expected to impact most industries. From advancements in remote communication to drone deliveries to autonomous vehicles, significantly impacts the way we interact with real estate. • Offices are impacted by changes in the way buildings will be occupied and managed. Retail and logistics are impacted through the disruptive influence of the Internet and e-commerce.
Demographics	• Millennials are driving the sharing economy, which is changing the way we use and interact with real estate and the infrastructure that facilitates it. • The impact of an ageing population will have a dramatic effect on the workforce, changing the profile of real estate demand. An ageing population will have different requirements from their home, workplace and leisure facilities. • There will be a renewed focus on saving for retirement and finding effective ways of drawing an income when people retire – further driving the appetite for real estate and real assets by pension funds.

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Shifting economic power	• In less than a generation, emerging markets have become an important destination for consumer goods and services now accounting for nearly 80% of global economic growth. • In 2005, China's economy was one tenth the size of the US economy. If it continues to grow as predicted, it will be bigger than the US economy by the late 2020s.[14] • The influence of emerging and developing economies can mean huge changes for business, with increasing demand for real estate from global investors seeking global diversification and long-term stable cashflow.
Urbanisation	• Populations are increasingly concentrating themselves in cities and large urban areas where there are better employment opportunities, education and access to social and cultural activities. • Mass migration increases demand for new infrastructure and services, potentially unlocking long-term real estate opportunities. • As population density grows to unprecedented levels, housing stock will need to evolve creating opportunities within the private rented sector. Existing healthcare systems will need to be overhauled to deal with increasing demand and opportunities could arise for healthcare-related real estate.
Sustainability	• The global population is expanding rapidly and becoming increasingly prosperous, leading to significant demand for energy, water, food and places to work and live. • The impact of global warming should not be underestimated. This is a global problem, and is further exacerbated by other megatrends, such as urbanisation and the significant growth in consumption in emerging markets. • Real estate is a major contributor to carbon emissions and is an increasing focus for both investors and occupiers who want to embed sustainability into their real estate occupation and ownership.

Source: BlackRock, August 2018.

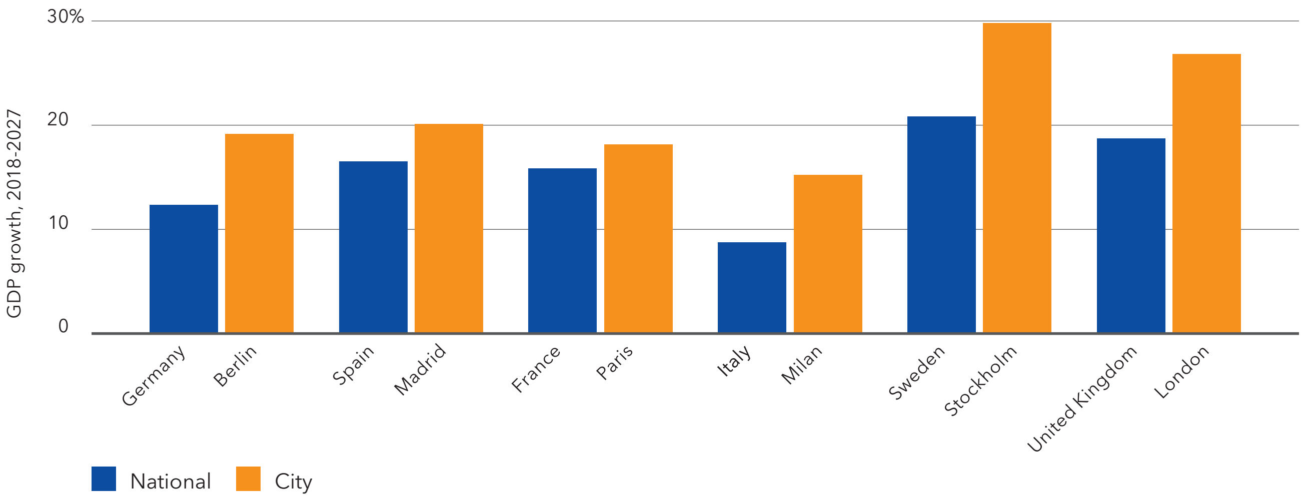
14 Source: BlackRock with data from Oxford Economics, June 2018.

European cities to continue to be the engine of growth for Europe

Europe is highly urbanised with a significant number of large (populations of over 500,000) and wealthy cities with favourable demographics and strong growth prospects. Many of Europe's most dynamic cities are growing at a significantly faster rate than their countries and they are expected to continue to do so in the future. As forecast by Oxford Economics, the population of the top 20 European cities is expected to increase by more than eight million people by 2030,[15] creating real estate opportunities especially around infrastructure corridors that are accommodating city expansion. In addition, some cities have evolved into high-tech hubs attracting big technology companies and start-ups, further boosting demand for real estate. Tourism is another key growth driver. European cities account for around a third of the world's top 50 tourist destinations[16] and international tourist spend is contributing significantly to Europe's leading tourist destination cities.

European cities are expected to continue to be the engine of growth for Europe as they expand and attract talent and tourism (Figure 11).

Figure 11: GDP growth outlook, 2018-2027[17]



Source: BlackRock, with data from Oxford Economics, July 2018.

15 Source: BlackRock with data from Oxford Economics, June 2018. There is no guarantee that any forecasts made will come to pass.
16 Source: BlackRock, Euromonitor International as at January 2017.
17 There is no guarantee that any forecasts made will come to pass.

Sustainability: a key component of future performance

Taking into consideration environmental, social and governance (ESG) criteria (Table 2) in investment decision-making is becoming increasingly important and research suggests an underlying link with investment performance, as stated in BlackRock Investment Institute's May 2018 report "Sustainable investing: a 'why not' moment".

Real estate can be a significant contributor to the key inputs of ESG ratings. Buildings are major producers of carbon and even small changes to their output can have significant impact on performance. In addition, the physical and long-term nature of real estate and the long duration of income means real estate assets can be significantly exposed to the risks and opportunities posed by global challenges such as climate risks, resource constraints and population growth.

Table 2: Breaking down ESG

Pillars and key inputs to ESG rating systems

Pillars	Key inputs
Environmental	Climate change risks Raw materials and water scarcity Pollution and waste Innovation, clean tech, renewable energy
Social	Labour policies and relations Product liability, including cyber security Controversial sourcing Social impact reporting
Governance	Shareholder rights, diversity Business ethics, transparency

Sources: BlackRock Investment Institute, April 2018. Notes: the table shows the three key pillars and inputs that underpin the ESG rating process across major providers.

Furthermore, changing regulation presents a real risk to the future performance of a real estate asset, its valuation and attractiveness to both occupiers and investors. Depreciation or obsolescence is an important consideration for determining value over time. Less sustainable assets might be subject to steeper depreciation curves as their utility and economic value is negatively impacted by changing regulation.

It is therefore implied that performance benefits will be most significant where we see sustainability – and a 'green premium' – taking hold. Rental rates for certified 'green' buildings can command premiums, as shown in the World Green Building Council's 2013 paper, 'The Business Case for Green Building'. Occupancy rates and retention also tend to be higher. Corporate tenants see green features boosting productivity and appealing to talent, while also supporting their own sustainability objectives.

Strategic implications for investors

The wide range of structural factors impacting the real estate market today are not independent but compound to create a heightened risk environment. As such, it is critical to appreciate both the risk and return implications of cyclical and structural change on real estate as we ensure portfolios are positioned accordingly.

In the current investment environment, the BlackRock European real estate view can be summarised as below:

- Maintain focus on established liquid markets and assets that produce low volatility returns and are cashflow generative.
- Leverage active management and development to reposition assets in supply constrained markets with low vacancy, such as key German cities, or in late to recover markets.
- In markets that are later in the cycle, focus on sectors that are benefiting from secular trends, like logistics and the private rented sector. Monitor the London market, which tends to move quickly, and be prepared to re-enter when the market adjusts.
- Mitigate portfolio against binary risks and a rising interest rate environment.
- Structural change can drive opportunities:

  – **Logistics:** opportunities both big box and last mile, particularly in markets yet to fully embrace e-commerce like Spain and Italy where online sales are less than 5% of total sales compared with the UK at 18% and Germany at 15%.[18]

  – **Retail:** focus on assets with strong catchment demographics, with clear offering along the experience/ convenience spectrum. Structural change will continue to impact the sectors but value can be found.

  – **Residential and living:** supportive structural trends such as urbanisation and growing demand from tourism and education, as well as an ageing population, create opportunities in the residential sector including the private rented sector, senior living and student accommodation.

18 Source: Statista, September 2018.

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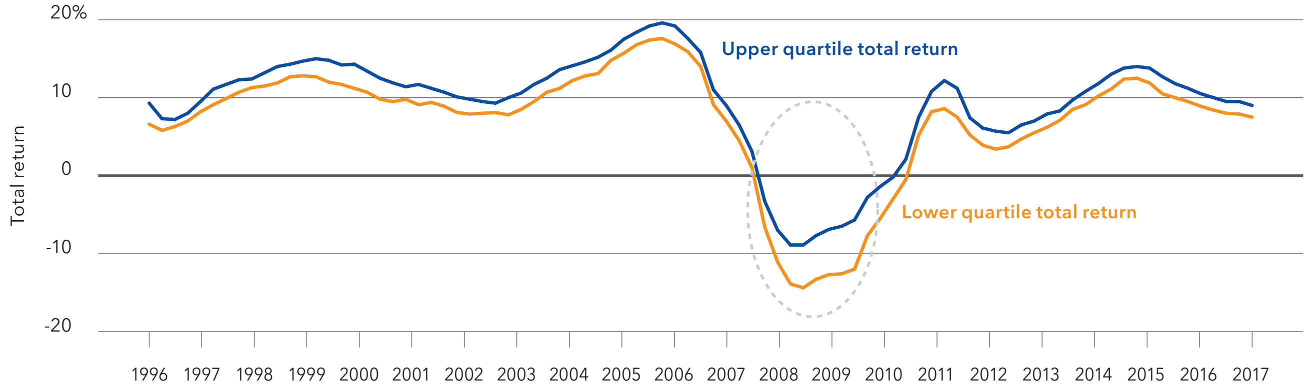
Investment discipline is critical in this market

Investors should beware of style drift in a market where allocations are increasing at a late stage in the cycle. This market behaviour contributed to the herding mentality observed in the previous cycle. Figure 12 shows the performance of core balanced UK funds which in theory pursue a similar core, diversified risk return strategy. Prior to the GFC the spread between the top and bottom performance quartiles was narrow, and relatively constant. However, the liquidity impact during the crisis exposed many funds that had followed others into less liquid markets and more risky strategies resulting in some experiencing twice the capital decline of others.

Figure 12: UK all balanced funds total return (three-year rolling average)



Source: BlackRock with data from MSCI AREF/IPD UK Quarterly Property Fund Indexes data sheet, June 2018. **The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results.** Note: MSCI's AREF/IPD UK Quarterly Property Fund Index measures quarterly total returns on a net asset value basis, in GBP. The index tracks performance of 45 property funds with a total net asset value of £52.5bn as at June 2018.

Real estate offers a range of risk/return profiles both in equity and debt and we have explained how post GFC, investor appetite for steady and low volatility income streams has been strong. The increasing weight of capital and rental growth in supply constrained markets has led to a highly competitive marketplace, elevating prices and raising the cost of entry. For investors the 'discipline dilemma', created by rising allocations in a market of moderating returns, is between accepting a lower level of return for the same level of risk or striving to deliver the same level of return whilst accepting a higher level of risk.

As our analysis suggests, mitigating against the downside by not chasing the market is equally a valid alpha generation strategy. Understanding cycles and structural change is therefore critical to delivering strong long-term, risk-adjusted returns.

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Important information

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