

SUMMER
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The Increasing Importance of Currency Risk in Real Estate



For many people, an early window into the world of real estate investing comes through the board game Monopoly, played somewhat reluctantly at family gatherings. Amid the inevitable tears, tantrums, and arguments about rules, kids and adults learn the value of real estate as an income-generating investment and the importance of properly managing cash flow. However, with only a single in-game currency, the all-powerful and highly coveted Monopoly Dollar, the game does not help people develop any appreciation for the potential complexity that currency can bring to the world of property investing. (Given how rancorous the game can be, this is probably a good thing!) Unsurprisingly, real life is more complicated, and for the increasingly large group of global real estate investors, currency risk is an important consideration.



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Historically, as a tangible asset class, real estate has had a strong home bias. MSCI surveyed a large group of institutional investors in late 2013 and found that, on average, 83% of real estate was domestically invested. However, this home bias is being gradually eroded as real estate is becoming increasingly globalized, driven by the world's largest sovereign wealth and pension funds, many of which have explicit global real estate mandates. More broadly, an improved understanding of the role of real estate within a multi-asset-class portfolio and an increased awareness of the potential diversification benefits from international real estate exposure are also helping drive cross-border investment. As this transformation takes place, real estate investors are increasingly being forced to consider the question of whether to hedge foreign currency exposures and, if so, how.

Why Foreign Exchange Risk Matters

Foreign exchange movements can have a substantial impact on the performance of international real estate investments. The MSCI IPD Global Annual Property Index explores how currency has affected past performance. Over the full 17-year history of the index, the annualized total return in local currency

(i.e., fully hedged without currency impact) has been 7.4%, and the standard deviation of the annual total returns was 5.8% (Exhibit 1).¹ Calculating the index in other currencies shows just how different the unhedged performance of that index would have looked to investors in different parts of the world.

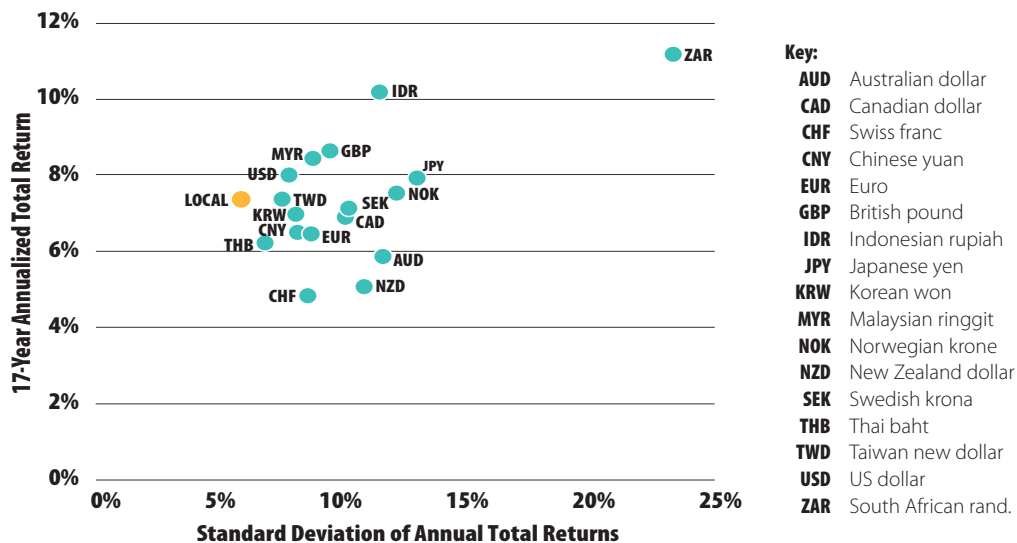
For example, measured in the South African rand, the index would have returned 11.2% with a standard deviation of 23.1%. From the perspective of a Swiss franc-denominated investor, the index would have returned 4.9% with an 8.5% standard deviation. The large difference in performance illustrates the substantial impact that currency can have.

Although Exhibit 1 highlights how much impact currency has had in the past, investors today may face even higher currency risks. Recent MSCI research found that, in the aftermath of the global financial crisis, foreign currency risk was increasing as a combination of quantitative easing, currency wars, and political uncertainty made currencies more volatile.²

How Foreign Exchange Risk Impacts Real Estate

Like other asset classes, foreign exchange risk to real estate can be broken down into three components: transaction, translation, and economic risk.

Exhibit 1: MSCI IPD Global Annual Property Index, 2001–2017



Source: MSCI Global Intel PLUS

Transaction risk arises as investment cash flows are converted into foreign currency. This could be converting purchase or sale proceeds, repatriating operating income, or expatriating funds to cover outgoings, such as capital expenditure. In certain circumstances, it may be possible to manage the timing of cash flows to mitigate transaction risk. For example, the repatriation of rental income could be delayed.

Translation risk arises when foreign assets and liabilities need to be converted back to domestic currency or reporting currency. This can be thought of as the accounting impact of foreign currency movements. Because only a small portion of the typical real estate portfolio usually sells in any given period and because the capital employed in even a modest real estate portfolio can be substantial, translation exposure can be as important as or more important than transaction exposure. For investors with substantial offshore holdings, adverse currency movements risk diminishing the value of their assets, and this may have further knock-on impacts for their financial health. Because translation risk is an accounting impact, it cannot be managed in the same way some transaction risks can be.

Finally, there is economic risk, which reflects that the underlying performance of foreign real estate assets may be influenced by exchange rate movements. A good example of this is Swiss retail assets: performance has deteriorated since 2011 as a stronger franc has hurt local retailers by driving more shoppers across the border to neighboring European countries.

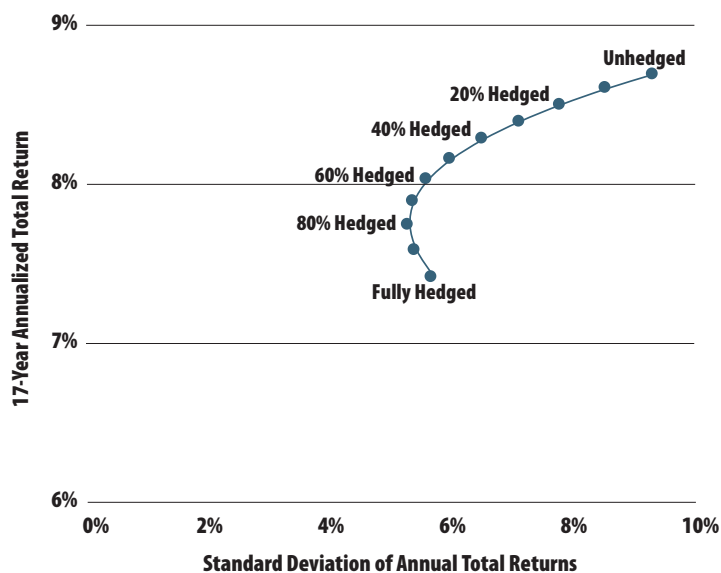
Hedging Currency Risk

Ultimately, it is not possible to do much about economic risk, but transaction and translation risk can both be mitigated through currency hedging. This can be done in several ways, with past surveys indicating that the real estate investment community has adopted a range of practices.³

Forwards, swaps, and options are some of the commonly used instruments for hedging currency risk in a real estate portfolio. Some investors may also borrow in foreign capital markets to reduce their foreign exchange exposure. However, the latter approach may simply substitute financial risk for currency risk, and the cost of borrowing offshore may be higher. Certain large global investors may also see their portfolios as sufficiently diversified to provide a natural hedge and not actively hedge at all.

For those that do decide to actively hedge, a key consideration is how much of the exposure to hedge. The answer is not straightforward because it depends on a large number of variables and because predicting future exchange rate movements is incredibly difficult. Assuming that a 100% currency hedge is optimal may be tempting, but numerous studies have shown that this is not necessarily the case, and the

Exhibit 2: Global Index Performance for a GBP Investor, 2001–2017



Source: MSCI Global Intel

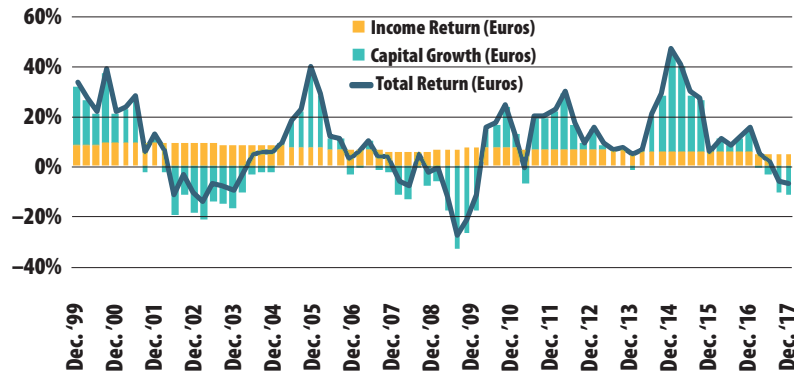
1. The MSCI IPD Global Annual Property Index is a valuation-based index, so the standard deviation should not be interpreted as a true risk estimate, but it can still provide an indication of how variable returns were over a time period.

2. Remy Briand, "Should You Hedge Your Foreign Currency Exposure?" *MSCI Research Insight*, 2016.

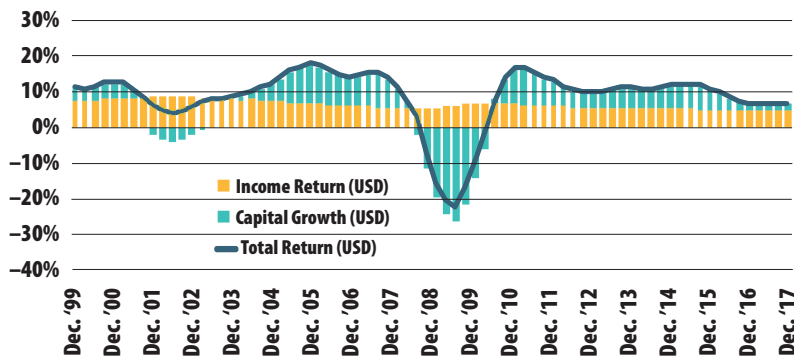
3. For an example, see M. Mansley, et al, *Managing Currency Risk in International Real Estate Investment*, IPF Research Programme, April 2018.

Exhibit 3: MSCI IPD U.S. Quarterly Property Indices

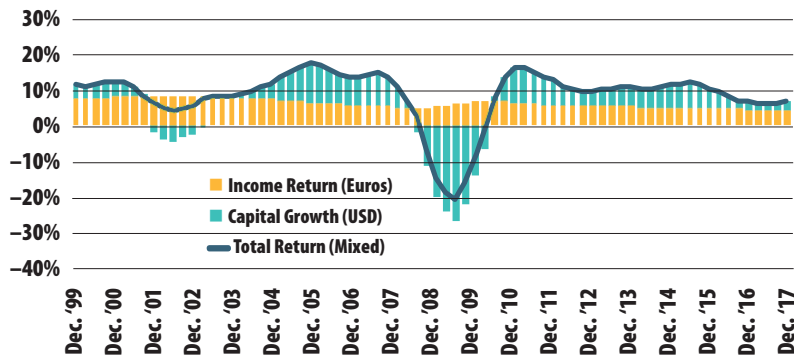
MSCI IPD U.S. Quarterly Property Index In Euros



MSCI IPD U.S. Quarterly Property Index In USD



MSCI IPD U.S. Quarterly Property Index Mixed



Source: MSCI Global Intel

variable, irregular cash flows from real estate make achieving a perfect hedge all but impossible anyway.

Let's ignore hedging costs and focus on the return performance of the Global Annual Property Index again to see how different levels of hedging would have impacted the performance of the index for a GBP-denominated investor over the 17 years to 2017 (Exhibit 2). Clearly, the relationship between the amount of hedging and the performance of the index is not necessarily linear. Higher levels of hedging reduced the total return as well as the variability of the valuation-based index returns. However, the reduction in variability slows as the hedging ratio increases and eventually reverses.

The desired level of hedging can vary considerably from investor to investor, and many factors might influence this. For instance, those with large exposures to currencies they expect to depreciate may want to hedge a higher proportion of their exposure for downside protection. Others with exposures to high-growth developing markets may expect future currency movements to be generally in their favor and therefore seek to hedge less, or even none of their exposure, so as not to limit the potential upside.

Another consideration investors looking to hedge confront is deciding which part of the return to hedge. Does hedging income return make more sense than hedging capital growth? Consider the position of a European investor buying US assets (Exhibit 3). The performance of MSCI's IPD U.S. Quarterly Property Index, used as a proxy, shows how much more volatile the unhedged (euro) returns would have been over the past 19 years compared to the fully hedged (USD) return. This additional variation is mostly a result of the translation risk to capital values. The impact of currency on income returns is not nearly as large. As such, a fully hedged capital growth return is combined with an unhedged income return,

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and the end result is that the bulk of the currency impact is stripped out of the performance. For this reason, investors generally prefer to hedge net asset value rather than income.

Who Should Be Responsible for Hedging?

As an asset class, real estate offers a number of investment avenues, either the direct acquisition of assets or the indirect option of listed and unlisted funds. In both cases, important decisions must be made about who is responsible for the implementation of hedging.

In the case of direct investment, if the real estate allocation forms part of a larger multi-asset-class portfolio, then the real estate team may have to decide how to hedge. But if these decisions are made in isolation, they may result in a suboptimal outcome for the overall multi-asset-class portfolio. This, together with technical complexities and knowledge requirements, may mean that decisions about hedging are left to a central treasury or finance unit.

For indirect investment, what is appropriate for one investor may not be appropriate for another. Therefore, some funds may not undertake any active hedging and instead leave it to their end investors, and others will hedge on behalf of their clients. Those who invest in real estate indirectly thus need to be clear about what foreign currency exposures they have and whether they are being hedged.

Some Added Complications

As much as some investors would like to reduce their foreign currency exposure, in the real world it is not always possible to do so.

There are a number of reasons for this, but some of the biggest hurdles are cost and regulations. The cost of active hedging can be quite substantial. Sometimes the

price of forwards, swaps, or options may be too high, and finding willing counterparties can be challenging. In other cases, a regulatory barrier, such as limitations on currency convertibility, can increase the difficulty of hedging. Additionally, market factors may be at play, and interest rate differentials, the willingness of banks to lend, and the general level of market liquidity can all make it harder to hedge foreign exposures. These complications can have a big impact and may even help shape global capital flows.

So Should I Buy That Hotel on Park Lane?

Whether you are a European investor looking to buy an asset in London or a North American investor with a substantial allocation in Asia, appropriate currency risk management is an important consideration. Given the large potential impact that currency movements can have, investors (especially those making their first forays into foreign markets) may want to carefully consider how they manage the additional risk that comes with cross-border investments. There are a lot of potential factors to consider, and many decisions may not be straightforward. But one thing is clear: As real estate becomes an increasingly globalized asset class, more and more investors could find themselves having to prepare for the challenges of managing foreign currency exposures. ■

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