Real estate as a long-term investment plays vital economic role

- Matches pension funds and insurers long-term liabilities
- Offers counter-cyclical investment strategy
- Stimulates employment, growth and innovation

Long-term investment enhances economic productivity and often has wider public benefits, by supporting essential services and improving living standards.

WHAT DIFFERENTIATES LONG-TERM INVESTING?

When investing long-term, investors are focused on long-term income streams more than capital appreciation and short-term price movements. It is not the duration of the holding period that is central, but the actual capacity of an investor to tolerate illiquidity, enabling it to hold assets through stress periods.

This distinction is critical when looking at the emergence of real estate bubbles. It is the strategy of short-term investors attempting to exploit market momentum that leads to large influxes of capital which drive real estate bubbles. Longer-term institutional investors, primarily focused on long-term income, typically pursue a counter-cyclical strategy and become net sellers during the booms.

WHY ARE COUNTER-CYCLICAL STRATEGIES IMPORTANT FOR THE REAL ECONOMY?

Counter-cyclical investing supports economic stability and fosters further sustainable economic growth. It also helps stabilise financial markets during downturns as long-term investors strategically buy under-priced assets. Counter-cyclical strategies allow the undertaking of long-term investing which facilitates product innovation, development and redevelopment of living and working space.

WHY IS LONG-TERM INVESTING IN REAL ESTATE VITAL FOR THE REAL ECONOMY?

Commercial real estate directly contributes 2.5% of European GPD and employs over 4 million people. A significant percentage employed are low skilled with limited transferable skills, often unable to find alternate employment. Overall every unit invested in real estate has a multiplier effect of 2.84 through the economy as a whole.

Real estate is also a vital factor of production and a source of competitiveness and flexibility for many European businesses and SMEs, freeing capital for innovation that would otherwise be used to buy property to carry out their business.

Long-term institutional investors also spear-head urban regeneration projects. They contribute to the rejuvenation of civic centres through the provision of retail, leisure, education and health facilities.

Importantly, real estate investment provides attractive yields along with long-term cash flows and portfolio diversification, while matching long-term liabilities. This safeguards the viability of long-term investing and is critical for providing the returns needed for European pensioners and savers.

Long-term investment strategies in real estate and infrastructure can take advantage of the longer-term

KEY HIGHLIGHTS

- ▶ Short-term investors and the increased availability of debt capital fuelled the real estate bubble
- ▶ Commercial real estate in Europe employs 4 million people and contributes 2.5% of GDP
- ▶ Long-term real estate investment helps insurance companies and pension funds meet their long-term obligations and contributes to sustainability improvements
- ▶ Regulatory requirements are causing a shift towards short-term investing
- ▶ Strong regions will continue to grow, while recovery in stressed areas will lag behind
- ▶ Capital of businesses and SMEs will be diverted away from innovation and growth

benefits of making sustainability improvements, reducing emissions and increasing energy efficiency. In contrast, shorter-term investing results in a greater emphasis on reducing short-term costs rather than implementing sustainable solutions.

IMPACT OF REGULATORY CHANGE

Proposed prudential regulations are designed to ensure that insurance companies and pension funds are able to withstand severe financial downturns. However, these regulatory changes are driving investors away from long-term investing by encouraging them to be overly concerned about short-term price movements.

IMPACT ON CAPITAL ALLOCATIONS

Regulatory capital requirements are an important factor affecting long-term investment strategies. Proposed solvency capital requirements overstate the risk of real estate investment, which creates a disincentive for long-term investing. Two other inter-linked requirements force them to focus on short-term price movements:

- Use of mark to market accounting for calculating capital requirements, while beneficial for other purposes, leads to artificial balance-sheet volatility for long-term liabilities.
- Disregard of duration matching and liability profiles for determining capital requirements exacerbates the impact of mark to market accounting, as it fails to discriminate investments according to their matched liability profile.

IMPACT ON THE POST-CRISIS INVESTMENT STRATEGY

The shift away from long-term, counter-cyclical investment strategies is evident in the current scale, timing and allocation of capital.

The proposed regulations exaggerate and prolong pro-cyclical and low volume investment trends due to their over-emphasis on short-term risk rather than optimising risk and return over the investment horizon.

The effect can already be observed. Currently, long-term investment volumes are low and the timing of investment is consistent with a pro-cyclical strategy. This is despite the context of the strong counter-cyclical opportunity that persists. Furthermore, investment strategies focus on prime assets in mature sectors of prime markets, leading to a concentration of investments and lack of capital in non-prime markets.

GEOGRAPHIC POLARISATION OF GROWTH

A decline in institutional long-term property investment would have detrimental consequences for the real economy.

The resultant narrow focus of institutional investment strategies on prime, income secure, high quality assets in a small range of principal markets reduces both the scale of economic growth and its sustainability.

This trend is particularly evident in distressed regions, further dragging growth and employment in those areas. Economic recovery is increasingly uneven as healthier areas rebound more quickly than those most in need of growth and jobs.

IMPACT ON SMES, COMPETITIVENESS AND INNOVATION

Ultimately, lower real estate investment will also result in a lack of suitable business space. It will drive up demand and prices of good quality rental assets.

Consequently business productivity and growth will be reduced due to real estate's intensive capital requirements and fixed asset characteristics. New and growing businesses will lack the flexibility and agility in location and employment dynamics required to maximise new opportunities.

When businesses need to buy rather than rent, it also ties up available capital, lowering their potential to invest in business expansion and R&D. Critically, business space shifts from being an investment asset to a product of consumption and, therefore, beyond its purchase, no longer contributes to the real economy.

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