MARKET TRACKER MAY 2018

Interest Rate Turnaround and Real Estate Allocation – how will asset managers react to a change of interest rates?

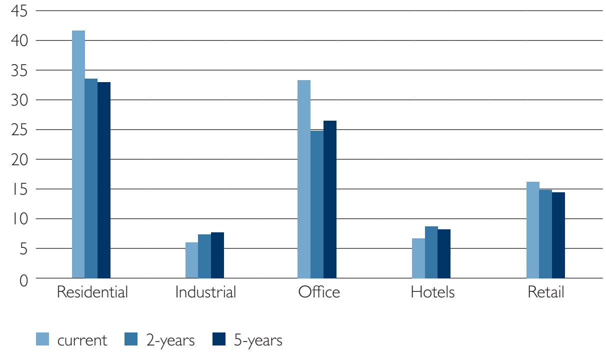
Since 2013, the tactical increase of the allocation quote in "alternative assets" or real estate can be observed in the majority of the Top 100 asset management companies in Germany – an average of 9.5% in the whole portfolio. In international comparison (16.6%), Germany is in a mid-range position. But what will happen in a multi asset portfolio in case of an interest rate hike if the share quota is automatically reduced and the percentage of real estate is increased? At this point in time, it can be useful to take a closer look at the current discussion on tactical and strategic asset allocation, especially with a focus on real estate.

The successive reduction of the quantitative easing programme of the European Central Bank can and will lead to an altered interest rate landscape in the coming quarters. The discussed renunciation of the so-called Draghi Doctrine in 2019, but also the reaction to the changes in trade and fiscal measures of the US-government, will lead to an adjustment of fiscal policies, financial regulations and the supervision of financial markets. Focussing on the financial service industry in the euro area, fiscal policies will be confronted with the need for adaptation. It is clear that from the time of announcement, or rather as soon as the first changes of the interest rate landscape can be measured in stocks, bonds and real estate markets, certain dynamics will develop – respectively different, definitely not synchronously and first of all influenced by systematic risk behaviour. In other words: Next to anticipatory effects of potential investments, short-term exit of real estate-portfolios and negative indications for listed real estate vehicles, largely heterogeneous effects can be measured.

Against the background of these developments, the basic sentiment in the real estate markets is worth taking a look at to find out if, within a forseeable period, a change in the attitude of real estate protagonists can be measured.

In March 2018, Catella Research took this as an occasion to question the Top 100-asset managers in Germany about their reaction to a possible interest rate turnaround. The focus was on the potential adjustment of their allocation strategy in the real estate markets and their fundamental strategic orientation.

FIG. 1: MID-TERM AND LONG-TERM ALLOCATION ADJUSTMENT OF ASSET CLASSES *
(in % based on interest rate changes)



* multiple answers possible

Source: Catella Research 2018

As can be seen in Fig. 1, investors will make some changes in the areas they invest in:

- Industrial and hotel properties have received more and more attention from investors in the past years. In the event of an interest rate turnaround, this trend will not be disrupted.
- The percentage of allocation in these two asset classes remains much lower than in the other three core-asset classes.
- Residential and office can record a relatively strong decrease of their respective share within the next two to five years. However, in the office-segment, an increasing trend will be recorded after 5 years.

Catalla is a leading specialist in property investment, funds management and banking, with operations in 14 European countries. The group has sales of EUR 200 million and manages assets of approximately EUR 16 billion. Catalla is listed in the mid cap segment of NASDAQ Stockholm.
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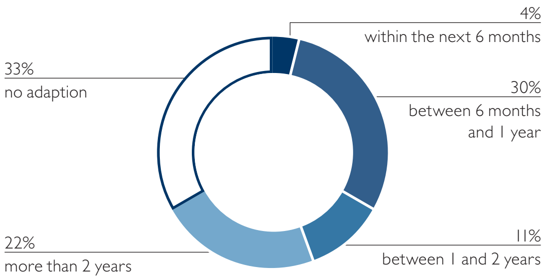
This shows that investors will continue to rely on niche-properties instead of core-classes, but only if the change in interest rates is not as strong as a look into the textbook of market reactions may lead one to believe. It can be presumed that these market segments, meanwhile, have an unsynchronised position in the universe of investments of multi-asset managers. Furthermore, a strategic time frame for investment and dis-investment can be seen, which is set for a period of 3–5 years.

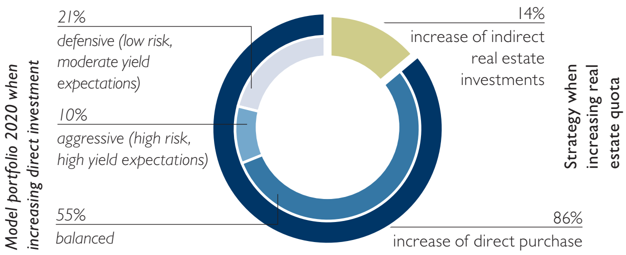
FIG.2: TIME OF ADJUSTMENT AFTER THE INTEREST RATE TURNAROUND (in % of the companies questioned)



Source: Catella Research 2018

Generally speaking, the market expects only slight structural effects of the potentially imminent interest rate change, at least when it comes to the Top 100-asset managers. Regarding the timing of a possible adjustment after an interest rate change as shown in Fig. 2, it becomes apparent that the majority (33%) of those questioned are not planning to make any adaptation in their portfolio allocation. Furthermore, 22% of those questioned will only consider an adjustment in more than two years time. 30% of those questioned, however, will adjust their allocation in the first six months to one year, which is the most popular adjustment time frame.

FIG.3: FUTURE STRATEGIES AFTER THE INTEREST RATE TURNAROUND (in % of the companies questioned)



Source: Catella Research 2018

Following the traditional market logic and based on the past steps of interest rate change, the negative effects for the real estate landscapes are ostensibly gaining significance. For the finance industry, the lack of savings, weak earnings and, thus, in a worst case, low risk tolerance when granting loans, were especially problematic, but seemed positively stimulating for the real estate industry as a whole. However, the low interest rates don't accurately reflect the risks of the real estate markets. In this situation, the question arises: What will the future strategies look like in this environment? The majority of the asset managers questioned (86%) will raise their asset allocation with an increase of direct purchase of real estate. 14% intend to increase the purchase of indirect real estate investments in order to counter-act the effects of the interest rate turnaround.

FIG. 4: INSTITUTIONAL INVESTORS AND THEIR REAL ESTATE INVESTMENTS

Market participants	Real Estate quota in %**	Holding period*
Investment companies (special funds)	50–70	3–10
Non-Property-Companies and industrial companies	15	>10
Charities	5–8	5–25
Banks and banking subsidiaries	4–12	5–10
Pension funds and -schemes	10	5–7
Family office/private investors	20–60	10–20
Insurances	8–10	5–15
Real estate corporations	80	>10
Investment companies	5–15	0.1–5
Housing associations/building societies	75–95	>15
Benefit funds	10–15	5–15
Real estate investors (other investors)	10	3–5
Project developers	80	0.5–2

N=462
* years, historical value + announcements
** average values, depending on market environment, investment law and regulation.
Source: Catella Research 2018

Summary:

Companies, who currently rely on direct investments in asset classes, will continue to prefer direct investments in real estate products. The same applies to some of the companies who currently invest in indirect real estate products, while others will switch to direct real estate products.

Larger companies with bigger employment figures and a broad spectrum of investments will be the first and the most likely to make an adjustment of all those questioned. These companies have a lower risk than other companies.

In the phase of low interest rates, businesses will avoid speculating in the funding of stocks and instead secure their assets with direct investments in real estate products.

The level of preparation in this process doesn't seem to be extensive as shown in Fig. 2, since in the case of a change in interest rates, there will be a delay – parties will act tactically and wait and see how the markets will adjust and then make their own adjustments of the strategic asset allocation. The rest is based on psychology and theory.