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Do Specialist Funds Outperform? Evidence from European Non-Listed Real Estate Funds

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Real estate presents challenges for both investors and managers given its heterogeneity, large lot size as well as the information and expertise requirements of different markets. It is not feasible for a single investment manager to be an expert on all property types in every location. Instead, real estate fund managers need to decide strategically what they consider their core expertise and subsequently structure their businesses and asset acquisitions in line with their expertise. However, investors also need to consider the risks emanating from a narrow focus and how to achieve a well-diversified portfolio whilst meeting their performance targets. In principle, they can build a portfolio of a mix of specialists by sector or country or choose more generalist, diversified funds.

This research aims to determine if specialisation leads to higher financial performance for European non-listed real estate funds. Specialisation may give managers better and earlier insight into investment opportunities arising from mispricing of individual assets as well as operational advantages, such as management efficiency and reduced costs. On the other hand, generalists are more flexible and hence able to avoid weaker markets whilst benefitting from insights from being diversified such as the ability to compare and contrast trends across a broader range of markets. Hence, it is important to determine whether specialisation in the real estate industry leads to improved investment performance or imposes constraints that limit the upside potential of funds. At the most fundamental level, real estate specialisation occurs in two aspects: 1) geography, i.e., companies specialising in particular countries; and 2) property types, i.e., companies specialising in particular sectors e.g. residential, office, retail or industrial properties. We analysed specialisation by sector, specialisation by county and sector-country specialisation (e.g. focused on a particular sector in a single country).

This study adds to the literature in three ways. First, it addresses the question of how international and sector diversification affects fund performance. Second, it controls for leverage, which previous research has not been able to because of data limitations. This is important since there are indications that leverage differs significantly between specialist funds and diversified funds which may distort the comparison on financial metrics. Third, this study controls for other structural differences that previous studies have not.

A general lack of available data has curtailed the ability of researchers to study non-listed funds but various industry associations such as the European Association of Investors in Non-Listed Real Estate Vehicles (INREV) have successfully removed some of these barriers by introducing performance measurement standards and capturing investment performance and fund characteristics. Our study is based on INREV data and analyses 4,272 fund-year observations across 592 funds over the period 2001 to 2019.

Our analysis finds that country specialisation is associated with superior returns, while sector specialisation does not generate superior returns compared to sector diversified funds. When defining specialisation in the country-sector dimension, the results show that country-sector specialised funds outperform country-sector diversified funds. However, outperformance of these categories mainly occurred during the real estate market recovery and growth period from 2010 to 2019. Furthermore, country specialist funds and country-sector specialist funds were more vulnerable during the financial crisis period than diversified funds. We also find that market returns, fund size, fund structure, fund age and vintage and gearing are significant drivers of returns.

The results of this study indicate that a strategy that uses several country specialist funds or a combination of country-sector specialist funds will most likely outperform a strategy that uses country generalist funds. This finding is consistent with other real estate research on the advantages of local and specialised knowledge. Additionally, the performance benefit of selecting a greater number of underlying funds will most likely offset the manager's search costs for investors (or the costs of using a multi-manager to identify funds). The evidence that sector specialisation leads to outperformance is less compelling. While a combination of country-sector specialist funds appears to deliver outperformance, it is primarily derived from country specialisation. Consequently, more attention should be placed on identifying managers/funds by country than identifying sector specialists. It should also be noted that these results are based on funds invested in the main real estate investment sectors (i.e., office, retail, industrial/logistics, and residential). It is quite possible that sector specialisation provides more benefits in alternative sectors, such as healthcare, data centers, and self-storage, where there may be greater operational risks and a greater need for sector-specific expertise.

A further important caveat to the outperformance of specialised funds is that they were also more volatile and more vulnerable to underperformance during the financial crisis than their more diversified counterparts. Assessing the impact on portfolio risk of specialists compared to diversified funds is an area for further research.

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