IPF Research Programme 2011–2015

DEFINING INVESTMENT QUALITY
JANUARY 2016

AT A GLANCE

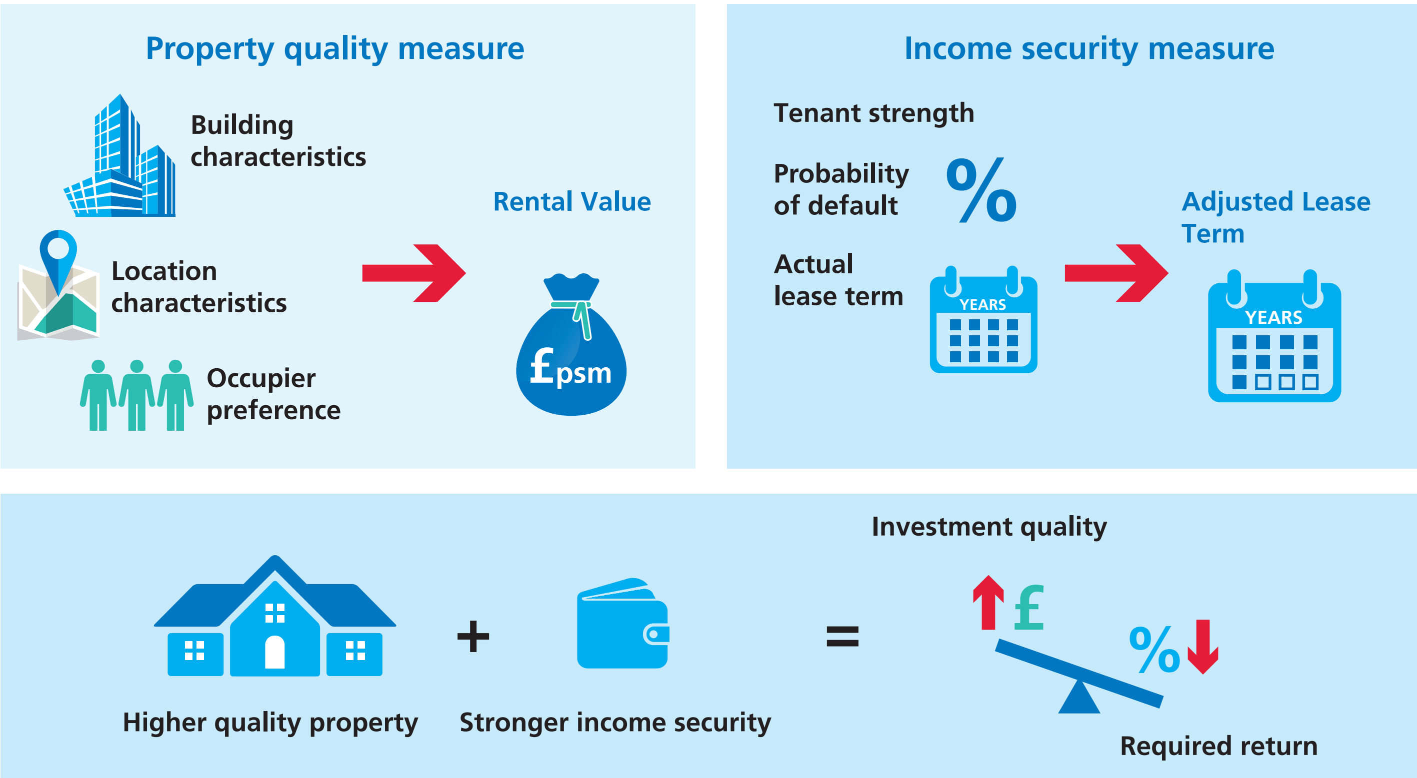
Background

- 'Prime', 'secondary' and 'tertiary' are terms widely used within the real estate industry to describe building and location quality.
- To classify a property's *investment* quality, objective criteria are required that are also sufficiently flexible to be capable of application consistently over time.
- This research seeks to establish an accepted industry-wide definition of quality and to develop a framework to identify the influence of quality on performance generation.
- The research identifies two components of investment quality (property quality and income security) and specifies a composite measure for overall investment quality.

Approach

- Rental value is proposed as the proxy for quality, being a practical means of distinguishing between properties of 'high' and 'low' quality.
- The income security of an asset is determined by the financial strength of its tenants and the remaining duration of their leases.

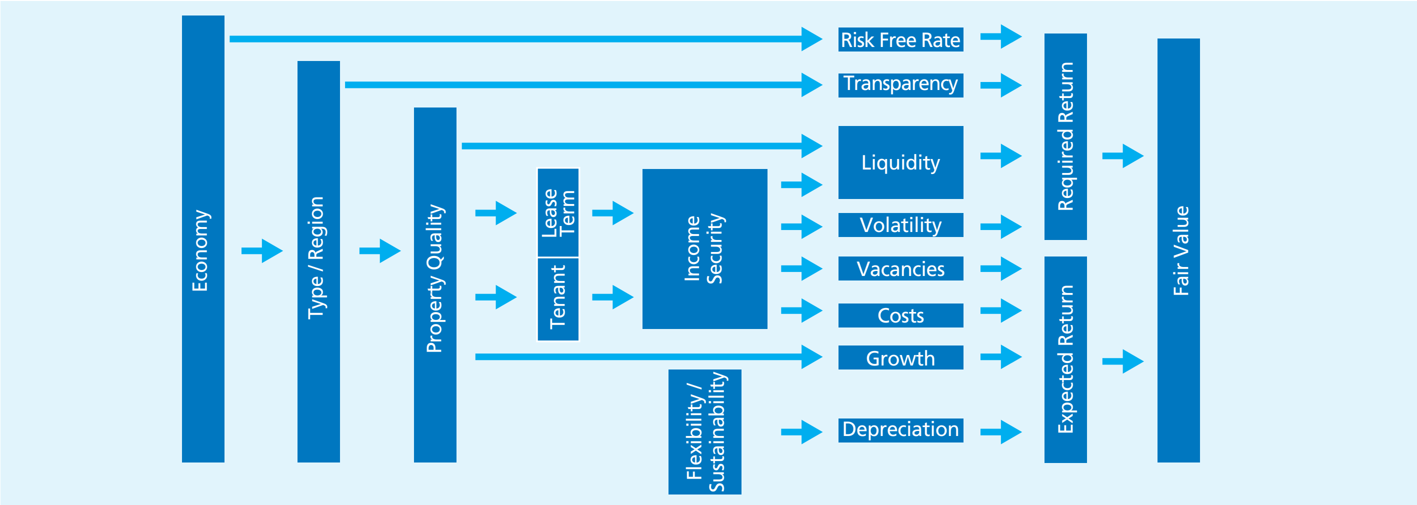
Components of Investment Quality



- The measurement of quality, as defined, permits a rigorous examination of the relationship between asset quality characteristics and returns.
- The quality definitions may also be used to link formerly disparate and fragmented data sources to provide the inputs required to facilitate forward-looking management of asset and portfolio risk.

PERFORMANCE GENERATION FRAMEWORK

- The framework developed by the research articulates how investment quality is central to systemic growth drivers and pricing. It explains why the performance of better quality real estate investments can often be closer to that of other higher quality investments of different property types than to poorer quality investments of the same type.
- The framework also explains why segments defined by property type and region account for only a small portion of the variation of *asset* returns, simultaneously reinforcing the importance of a type-region typology as the underlying driver of *market* returns.



- These findings have implications for portfolio construction and risk management: an allocation strategy that creates a portfolio comprising a range of assets of differing types, in different regions, of varying quality and with a range of lease terms, should generate a return close to that of the market average.
- Where assets with similar characteristics are concentrated, such as in specialist portfolios containing poor quality assets with short leases or better quality assets with long unexpired lease terms, these will generate a return that tracks the average performance of other assets with those particular characteristics.

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