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Diversification when It Hurts? The Joint Distributions of Real Estate and Equity Markets1

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Abstract

This article examines claims about the diversification benefits of real estate. In particular, does real estate investment in a mixed asset portfolio provide protection when other asset classes are performing badly? Conventional portfolio strategy models utilising covariance statistics may result in a misallocation of capital if correlation structures between assets differ across the distribution of returns. Models of asymmetric dependence using the copula function, drawn from the recent finance literature are used to examine the relationships between real estate and equity at different points in their joint return distributions. For both UK and Global markets, real estate securities and common equities are shown to exhibit strong tail dependence – particularly in the negative tail. This suggests that real estate securities offer, at best,

limited diversification protection when it is needed most – when other asset markets are falling. This has implications for allocation strategies in mixed asset portfolios.

1. Paper originally presented to the European Real Estate Society Annual Conference, Dublin, June 2005.

Keywords:

Copula portfolio diversification tail dependence real estate

Notes

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2. Or, for professional investors, by investing in securitized or unitized property vehicles in the private market.

3. However, Lu and Mei (1999) observe that international real estate stocks show a higher correlation with US stocks when US markets are performing badly, implying diversification gains are least when investors need them most.

4. Other de-smoothing models produced very similar results.

5. GPR is preferred to EPRA for the time-series and the availability of pure closed-end data series.