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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, suggest that real estate equity at different times may provide a hedge against equity at different times. This paper examines the dependence - in particular, the asymmetric dependence - between real estate and equity markets, at best, and the implications for real estate portfolios. The paper is based on data from the ERES conference, Dublin, June 2005.

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Notes

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

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