Insights

Portfolio management and geographic diversification

Geographical diversification is an important tool for reducing portfolio risk by avoiding excessive ownership concentration in any one market.

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Diversification in general

Diversification, generally speaking, is the practice of allocating capital to a variety of investment asset classes, risk categories and geographies so investors essentially don't have all their 'eggs in one basket'.

For the same reason an investor would likely not want to have all their investment exposure to one particular stock (or one asset class), it follows that its simply not prudent for an investor to have all their money invested in a single country (or single region), where a failure in either could be detrimental to their portfolio, given the over-weighting.

Understanding geographical diversification

Geographical diversification is based on the premise that financial and real estate markets in different parts of the world are not highly correlated with one another.

For example, if occupancy trends in European real estate markets are being structurally challenged, or good purchase opportunities are becoming rarer due to concentrated institutional ownership, or pricing competition for quality assets is compressing yields to unappealing levels, an investor may tactically choose to allocate part of their portfolio, to an alternative geography which in contrast, offers greater transaction volume potential, superior risk-adjusted returns (than those available in their home market), and exposure to a different economy and set of tenants.

The Pros and Cons

Diversifying a real estate portfolio across different geographies can undoubtedly help investors compensate for the potential volatility of a single economic region and in the long term, reduce risk relative to a less-diversified portfolio.

While geographic diversification does come with its own set of risks and additional considerations (such as the potential for currency fluctuations, double taxation and unstable political systems), diversification to established markets such as the U.S., doesn't carry anywhere near the same levels of risk as a developing or an emerging market may do.

The counter-argument

While a counter-argument exists that everything in our global economy is now interconnected, and that accordingly, spreading investments over different geographies doesn't provide the same level of diversification benefit as it once did.

While that argument could potentially be upheld in the case of listed securities, in the world of commercial real estate however, we believe it to be a different story.

International diversification of real estate is an essential component of prudent risk management, and should be a part of any well balanced and composed investment portfolio - as should further diversification at the sub-asset class level.

Source: Unity Capital Partners / Investopedia.

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