Kepler | Trust Intelligence

A winning formula

SERE provides diversification and a focus on fast-growing cities...

It was the late economist Harry Markowitz who reportedly said that diversification was "the only free lunch in investing". Essentially, finding the perfect mix of assets should mean that you can sleep better knowing no one 'Black Swan' event will blow up your entire portfolio.

The concept of diversification generally encompasses a portfolio in its entirety – you should own stocks, but also assets such as bonds, property and gold to maximise your risk-reward profile.

Yet, it's just as key to think about diversification within each of the assets that you own. Make sure you invest in different regional equity and bond markets, for instance. The same goes for your property exposure; unfortunately, this is easier said than done for UK-based investors.

Once you've chosen from the 12 investment companies dedicated to UK commercial property for your access to your domestic market, where do you go for overseas exposure? The choices – European logistics warehouses, German residential or Cuban real estate – are few and far between.

Step in **Schroder European Real Estate (SERE)**, the only option for investors wanting to tap into the income and growth potential of a diversified portfolio of direct real estate in continental Europe through an investment structure that is ideally suited to such an illiquid asset class.

The ability to diversify a portfolio beyond UK shores makes SERE a compelling option for investors, but it's by no means a one-trick pony.

Why Europe?

The UK is a mere minnow in the context of the wider European investment landscape. The Continental European real estate market is larger and more diverse than the UK's.

Indeed, of the top 30 European cities in Oxford Economics' Global Cities Rankings, only two (London is first and Manchester 28th) are in England, with the rest spread out around the continent.

On a sectoral basis, Europe looks attractive versus much of the rest of the world.

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Take offices: vacancy rates in Europe are around 7.8%, well below the global average of 15.9%, suggesting that Europe is doing just fine in tempting workers back into their daily commuting regime as well as benefitting from tighter planning and lending laws, limiting speculative development (Fig. 1).

In addition, manufacturers are re-assessing their dependency on China to a more diversified manufacturing approach. Parts of Europe may benefit from this.

The European Central Bank is further into its interest rate loosening cycle than both the UK and US, too, having cut rates twice already, in June and September. As a result, government bond yields have fallen. At the same time, property yields have risen, not only because values have fallen but also because rents have grown with property keeping its inflation correlation intact.

The gap between property and bond yields looks more compelling than it did two years ago.

SERE's dividend yield is hovering around its lifetime high in absolute terms, c. 7.5%, and the spread over 10-year German government bonds, yielding c. 2.2%, is therefore c. 5.3 percentage points, above the five -year average.

Underlying SERE's dividend yield, the net initial yield on the portfolio is now 6.8%, a significant spread, 4.6 percentage points, over the same government bond yield.

Winning cities

SERE is predominantly exposed to regions of Western Europe with high rates of growth. In fact, as you can see from the pie chart in Figure 2., 89% of SERE's portfolio by value is invested in either the fastest or second fastest growing quartiles of regions in Europe, versus 65% for the wider investment universe.

This is a corollary of the managers' process, which we **outline here**, that focuses on identifying cities with a competitive advantage such as a diversity of business, a deep talent pool, good infrastructure and tourism, alongside some smaller economies boasting higher-value industries. Essentially, these are places that people want to live, work and travel to.

Winning assets

As well as providing shareholders with diversification, SERE itself is well diversified across cities, as we've discussed, but also by asset, tenant and sector.

As mentioned, office markets in Europe have remained robust,

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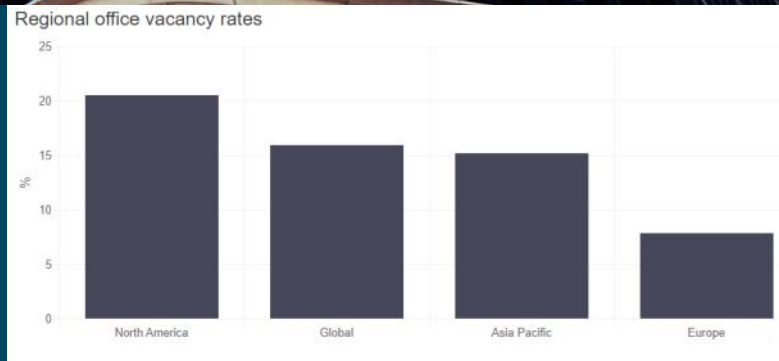
FIG 1:

'European offices are fuller than elsewhere'



Source: JLL, Schroders

FIG 2:

'SERE is overweight the highest-growth regions of western Europe'

Source: Oxford Economics, Schroders

with demand for high-quality working spaces remaining strong. In the industrial sector, demand for logistics and warehouse assets continues and in retail, the trust is exposed to grocery and DIY, areas that are less susceptible to the structural headwinds that are hindering fashion and leisure assets.

Being diversified gives the trust access to a much broader pool of opportunities. A recent example is its acquisition of a car showroom in Cannes – an investment that sector specialist REITs would be unable to make.

Feet on the ground

One benefit that cannot be overstated is the depth of knowledge and experience that SERE can pull on. Schroders is one of the largest real estate managers in Europe and the trust benefits from having a plethora of feet on the ground in the key markets.

SERE's manager Jeff O'Dwyer has over 25 years' experience in real estate, including over 20 years in Europe. He has worked in Germany and Italy before, as well as having stints in Australia and New Zealand.

Jeff is supported by a team of c. 200 real estate professionals based in cities across the continent, such as Paris, Frankfurt, Amsterdam, Stockholm and Zurich.

The team was expanded in 2022 through the acquisition of Cairn Real Estate, a 30-strong team based in the Netherlands, giving Schroders Capital significant extra resources in what it views as a key growth market for European real estate.

The on-the-ground teams manage each asset as a business by itself, with a tailored business plan, deeply engaging with local tenants to optimise long-term sustainable income and value across the lifetime of the investment.

The time may be nigh for property and it's not just a UK-only story – ensuring you have geographical diversification can provide different drivers of growth within a portfolio.

Read our analysts' latest research on Schroder European Real Estate

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