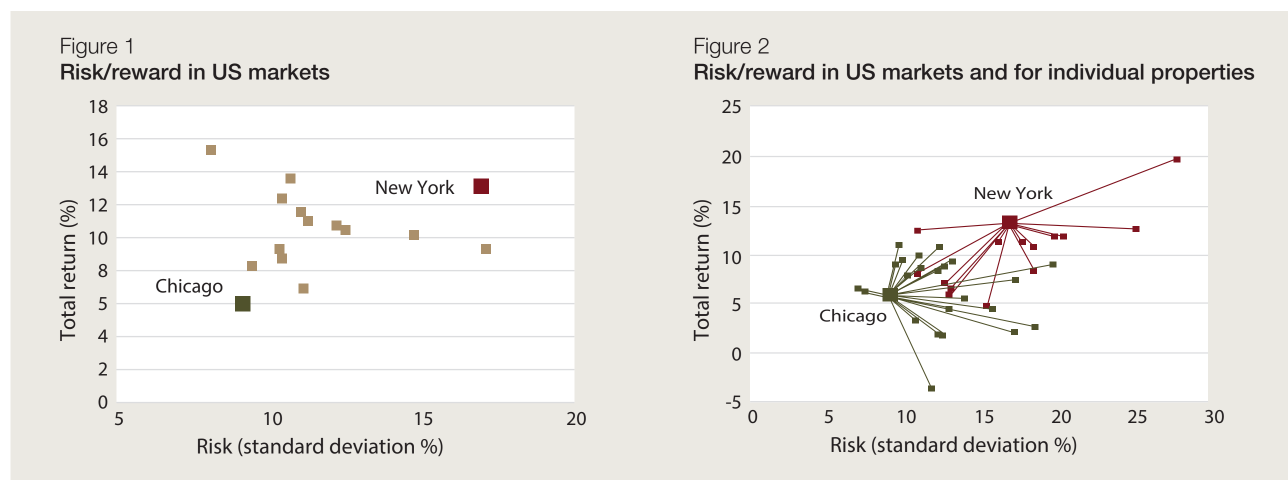
No. 5: Property-specific risks dominate market risks

Properties have a fixed physical presence and, unlike businesses, are not really scalable. While a global corporation can start out in someone's garage, the garage itself will never become a global corporation. The SPI Swiss Performance Index, with a solid 200 components, covers practically the entire universe of listed Swiss companies. On the other hand, there are roughly 500,000 flat complexes in Switzerland alone. Most investment properties in turn belong to just one person or legal entity, while Nestlé for example has about 250,000 shareholders.

Thanks to the individual, geographically fixed nature of property, its economic risks are based far more on the asset-specific characteristics than is the case for shares. The share price for the majority of all international insurance companies, for example, shares a similar fate owing to the related business models. In contrast, the majority of individual office properties in Geneva do not behave like the overall Geneva office property market.

MSCI has illustrated this using an example from the US real estate market: The entire US market was first categorised into regional clusters (figure 1). However, within Chicago and New York – regions that differ in terms of their risk/reward profile – the individual properties are so far removed from the index that the common reader would think most properties belong in another region's cluster (figure 2). It is also striking that the risk stated by the index for Chicago is 9% while what looks like the centre of the dot cluster for all Chicago properties seems to indicate a risk of about 13%. The lower risk for the overall market is based on a diversification effect underlaid by a low correlation of the risks between individual properties.



It is important to recognise when building up a real estate portfolio that a regional concentration with a small number of properties does not necessarily produce negative results. The property-specific risks, such as flawed construction of flat roofs or the unforeseen removal of a nearby bus stop, have little correlation with the risks of other assets (real estate, shares, bonds, etc.).

In summary, a small real estate portfolio with a regional concentration can still be well diversified. It only becomes a problem if similar (systematic) risks begin to accumulate from multiple properties.

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