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Navigating Country Risk in Global Real Estate

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Executive summary

Spreading risk can help generate better returns, but being able to measure and navigate that risk is challenging. We believe investors typically underestimate market risks and that trying to understand risks is a worthwhile exercise.

Real estate risk is multidimensional. It can be broadly split into property-specific risk and market risk. Each of these buckets contains further subsets of risks. Country risk is one element of market risk, and this paper specifically considers ways to measure this risk and how to implement a consistent approach.

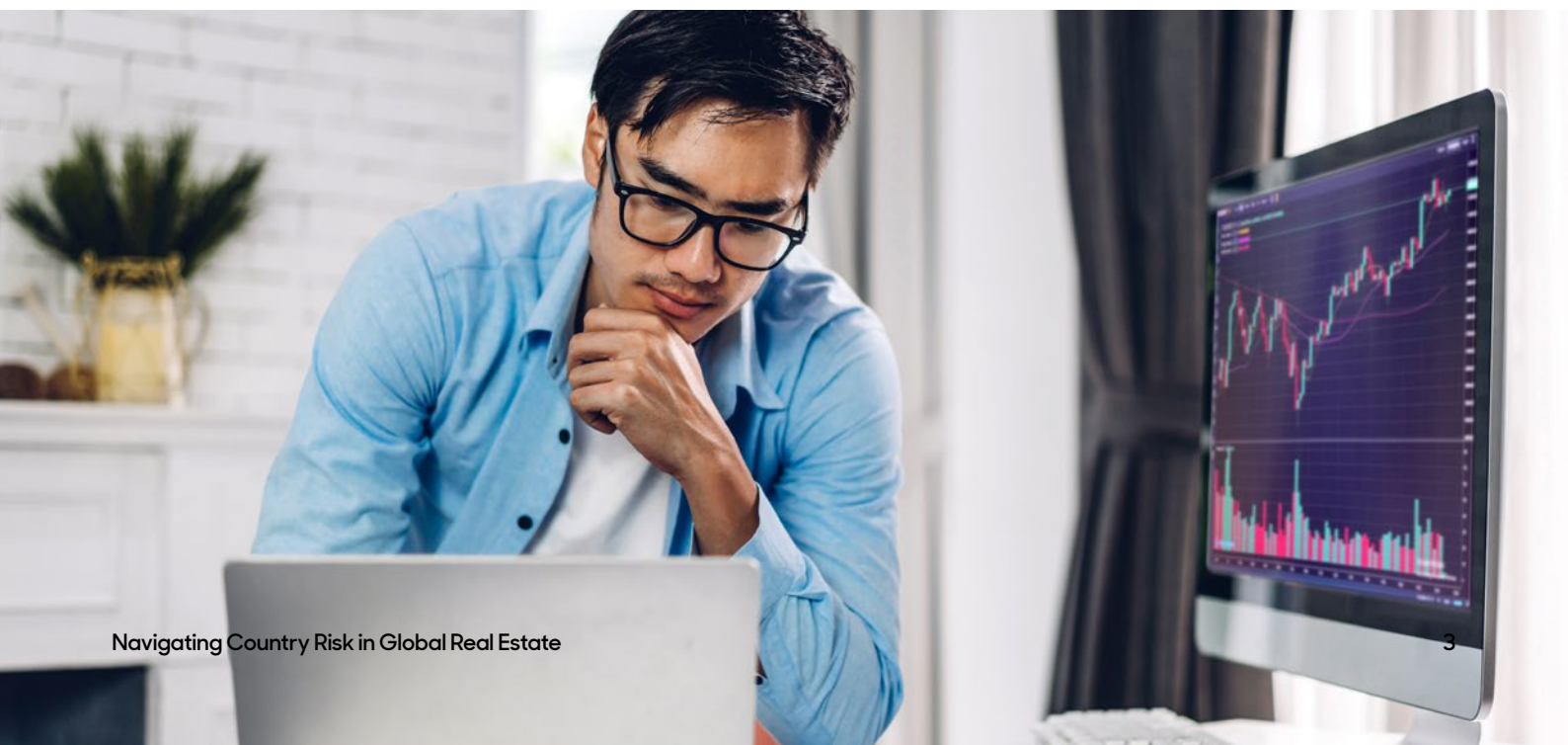
Country-specific risk can be further broken down into real estate risk or environmental, social and governance (ESG) risk. We view ESG risk as being increasingly important to future real estate performance, and this has become a key element of our country-risk evaluations.

Evaluating and understanding country risk is key to successful investing. It is not necessarily about relative total returns between countries, but about the probabilities of executing a strategy within a specific country or set of countries, with an outcome as close to the initial business plan as possible – be it a core mandate or opportunistic.

The **abrdn RE: GlobalRiskNavigator** (GRN) is a proprietary tool we have developed specifically to quantify and understand the level of country risk across the world. It uses both robust third-party industry data and abrdn's proprietary data to score and rank implementation risk across countries.

Large, well-developed, transparent European markets have the lowest level of country risk, closely followed by the North American markets. APAC markets have a moderately higher amount of country risk. Across all regions, there is a broad spread between countries. The standout lesson is that Europe carries a substantially lower level of ESG risk compared with the other regions. This is broadly reflected within each country, too, aside from Spain.

Our proprietary **abrdn RE: GlobalRiskNavigator** is key to determining whether the expected level of return from a particular country justifies the underlying country risk (in addition to the asset- and sector-specific risks). It also gives investment managers clarity about country risk on a consistent and unbiased basis, allowing for an informed assessment of portfolio allocations.



The rising importance of ESG as a real estate risk factor

ESG risk factors are becoming increasingly material. This is notable not only from a regulation perspective but also from real life impacts, such as those arising from climate change in the form of extreme weather events and other environmental and social trends. Although real estate investments represent approximately 3% of total financial capital, the real estate market represents 39% of total CO2 emissions and 36% of energy use (Source: INREV, *Falling through the cracks: SFDR's impact on real estate investment*). This means that the impact of ESG performance on investment performance is becoming more tangible.

If these risks aren't addressed, real estate assets could face non-compliance fines, increasing insurance costs, and potential stranding from both a liquidity and occupier demand perspective. Addressing ESG risks early can limit these negative impacts and create opportunities. For example, refurbishing an asset in line with net-zero principles could contribute to lower void rates, as occupiers are more likely to choose assets that have lower energy costs. The income from solar panels can also be included in valuation assessments.

However, addressing ESG risks incurs high upfront costs to futureproof assets to meet upcoming ESG legislation, the majority of which is focused on net-zero. This can have a shorter-term impact on investment performance, but ultimately sets the asset up for success and better long-term performance. The frequency at which to assess ESG risks and incur costs to minimise them also depends on the country and asset type. This is because of the varying level and approach to legislative levers, and local climatic and social conditions. It is therefore important to understand the breadth and timing of ESG risks across different locations.

Over the last two years, for example, we have seen the introduction of significant ESG legislation at the national level for real estate. In the United Kingdom, for example, it's not possible to let an asset with an energy performance certificate rating of F or G. This is expected to rise to B in 2030. There has also been new regulation for biodiversity, which requires a 10% biodiversity net gains for new developments. Elsewhere, France introduced the Tertiary decree, which mandates energy and carbon disclosure and reduction targets. And the Netherlands created a minimum energy performance certificate requirement of C for offices.

ESG risks and their materiality are increasing and they can't be ignored. The **abrdn RE: GlobalRiskNavigator** is designed to make sure we are managing our strategies in a more informed way, by including ESG considerations alongside more traditional risk factors.

Georgie Nelson,
Head of Real Estate ESG



Section 1

Why do we need to understand market risk and what are the primary components of real estate risk?



Why do we need to understand market risk and what are the primary components of real estate risk?

"A bend in the road is not the end of the road, unless you fail to make the turn", according to US activist Helen Keller. In real estate investing, there are plenty of bends and the occasional hidden dip, but there are things we can do to make sure we are ready to navigate the course and to complete our journeys.

In previous papers, we have explored the wide range of historic returns and volatility across countries, sectors, asset quality, investment styles and individual assets. From this research, it has become clear that market risks are often misunderstood and underestimated. Many risk measures focus too much on volatility and are hamstrung by data issues. This is either because the variation and risk to performance is not evident in the data (see for example German or Italian real estate index data), or because investors' experience has been different to that reflected in market trends – for better or for worse. With so much change taking place in the global economy and with investment markets also grappling with disruption, such as the impact of companies specialising in artificial intelligence on the performance of the S&P index in the first half of 2023, we believe it has never been more important to get a grip on the risk factors.

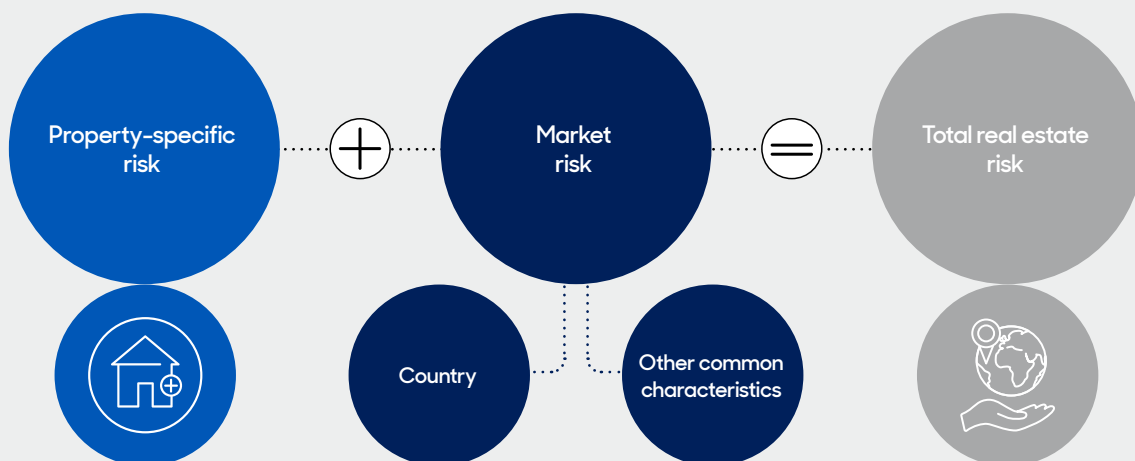
After all, risk heavily influences an investor's chances of successfully implementing a planned strategy over time. The extent of risk exposure is a choice at the outset, but it

can change over time with the economic cycle, and as a result of structural or exogenous changes in the market. This paper introduces and explains abrdn's proprietary tool for assessing the 'country risk' component of real estate risk.

In real estate, risk and reward are apparent in the characteristics of physical properties and in the markets to which they belong. These elements are not mutually exclusive and getting them both right is important in deriving stronger performance. **Analysis from MSCI shows that multinational portfolios have derived 50% of their relative return from their market allocations and 50% from property selection.**

Part of getting the market selection right is navigating the incumbent risks in each country. We consider country risk to be one component of overall market risk (see figure 1). The impact on real estate performance from country risk can be powerful and sudden, given the physical and rigid nature of buildings in stark contrast to the fluidity of country risks. Social unrest in Paris, Brexit in the UK, wildfires

Figure 1: Country risk in context



Source: abrdn, June 2023.

in Australia and political change in Hong Kong are examples of risks that have been unique to certain countries and that affected the performance of their real estate markets. Aside from the countries where assets are located, there are other commonalities that form a component of market risk. These include the sector, quality, age and investment lot-size of the asset, all of which can influence performance.

Whether an investor is exposed to one market, or is investing across multiple markets, understanding the constituents of market risk are critical. Every investment, be it domestic or cross-border, is making an additional new allocation to the market risks in that country.

We have been tracking country risk in a measured way for many years, focusing on factors such as transparency, liquidity, economic risk and political risk. Yet we believe that the subset of risks within each country are evolving. This is why we have introduced a more forensic approach to environmental, social and governance risks (ESG risks), and we have attributed a 50% weight to this component. We explore the reasons for this in more detail later in the paper.

Country risk is multi-dimensional and not static

Measuring country risk is subjective. Country risk is multi-dimensional, coming from a range of different factors, and it isn't static. However, this should be seen as a challenge rather than a barrier. We believe that by selecting the right component, it is possible to have a framework to contextualise risk exposure within strategies and to have a better idea whether returns truly compensate for the risks being taken.

Recently, there have been examples of country risks coming to fruition, which have negatively affected short- to medium-term returns. During the EU debt crisis, for example, investors were concerned about countries defaulting on their sovereign debt. Insurance against defaults for Spanish, Italian, Irish and Portuguese debt instruments soared sharply, and pricing and liquidity for real estate assets was negatively affected. This made it difficult for investors to exit investments without taking significant write-downs on valuations. We have also seen political events, such as Brexit and the independence referendum in Catalonia, lead to adverse real estate market performance.

If the risk event is large enough to affect the strength of the local currency and the weak performance hurts domestic investors, then it can have a stronger negative impact on cross-border investors.

Figure 2 offers a summary of some country risks that have significantly affected the investment market.



Figure 2: Table of markets experiencing events that have affected market performance and asset level returns

	Country	Risk factor	Date	Impact
	Netherlands	Stamp duty hike to 10.4%	2023	Stamp duty hiked from 8% to 10.4%, knocking 2% off real estate total returns in one quarter. This had a clear impact on liquidity.
	Spain	Catalonia independence referendum	2017	The referendum and the result, albeit declared unconstitutional, hit the Spanish real estate market hard. This was particularly the case for Barcelona, which saw a greater risk premium introduced for regional real estate and a sharp drop in liquidity.
	Hong Kong	Political change and social unrest	2019–2020	Outflow of business headquarters to Singapore and other more stable business environments.
	Central Europe (CEE)	War in Ukraine	2022 to present	CEE markets rely on cross-border capital for 90% of transactions. Investors have pulled back and liquidity has suffered significantly.
	Brazil	Bolsonaro and Covid-19 policy	2019–2023	Political instability and a controversial approach to the Covid-19 pandemic led to Brazil becoming a less investible market for cross-border investors. Bolsonaro also failed to improve the reputation for corruption in politics.
	UK	Brexit impact on currency	2016	Significant impact on currency, real estate liquidity and market sentiment. Sharp underperformance of the market in foreign currency terms.
	Italy	Political instability	2022	Frequent parliamentary elections and prevalence of more extreme parties deterred international capital.italt
ESG risk factors	Australia	Wildfires	2019–2020	2019/2020 wildfires across 12.6 million hectares killed 400 people, 100,000 livestock, destroyed 3000 homes and killed an estimated one billion native animals. In January 2020, Canberra recorded the worst air quality of any city in the world.
	Germany	Drought	2022	Droughts in 2022 led to economic uncertainty. Freight passage through the Rhine at Frankfurt was closed for 132 days, leading to a significant reduction in output.
	Italy	Flooding	2023	Italy's worst flooding for 100 years caused 305 landslides, 15 deaths and 36,000 homeless in 2023. A €2 billion aid package was created as 15 million fruit trees were put at risk.
	Spain	Climate change and drought	2022–2023	Spain's agricultural industries are suffering from drought conditions that are only expected to worsen. Rainfall has fallen by 26% between October 2022 and May 2023, compared with the same period a year earlier. Olive oil production is expected to fall 25%, affecting overall economic output.
	Germany	New rules on housing stock efficiency	2022	Housing needs to meet new emissions targets to avoid new taxes being levied on investors.
	France	Pension reform and social unrest	2023	Protests against the proposed increase in the retirement age from 62 to 64 were met with violent protests. Physical damage to various city centre properties across France were recorded, whilst many businesses incurred a loss of revenue and the costs of securing properties during the unrest.
	France	New renewable energy policy	2023 to present	To encourage a greater reliance on renewables, all car parks with an area greater than 1,500 square metres must have 50% of this area's energy supplied by photovoltaic cells by 2025.

Source: abrdn May 2023.

These political, economic and environmental risks have formed part of most country-risk assessments, alongside real estate-specific risks, such as market transparency and liquidity. However, ESG factors are becoming much more prevalent in determining the risks to real estate performance from one country to the next.



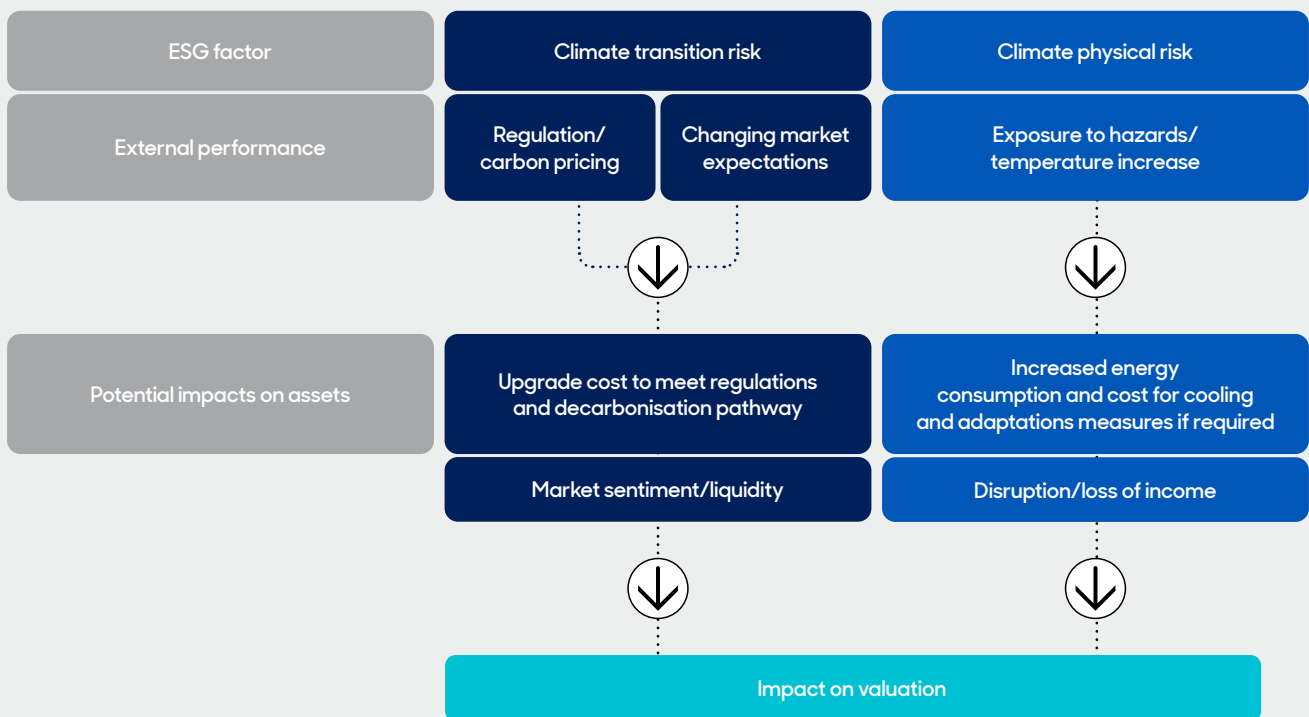
Taking climate change specifically, these risks come in two forms. Firstly, transition risks determine how well a country can adapt to climate change or to new green energy-related policies. Secondly, physical risks relate to climate change itself, such as how vulnerable an economy is to rising temperatures or to more extreme weather conditions (see figure 3).

Some countries are more exposed to climate change than others, while some are better equipped to handle the impact of it too. Record temperatures are regularly being set in India, while Spain has recently set a record temperature for April at around 42 degrees Celsius. In Germany last year, the economy was hit by both drought and flash floods in the west of the country, events that disrupted production and supply chains.

Flood risk is another climatic factor that has a differentiated level of risk between countries. The Netherlands is more at risk from the physical impacts of rising sea levels, yet the impact is twofold. Firstly, the potential flooding could have a physical impact on assets, such as damage to the structure or fabric of buildings. Secondly, there is an increased costs associated with protecting assets from flood risk. These risks are becoming specific costs that will affect investment performance. This makes the ESG component of our country risk model more tangible.

Figure 3: How the components of climate risk affect real estate

Components of climate risk on real estate performance



Some countries are already better placed to deal with rising climate impacts, with regards to transition and physical risks. Investors currently perceive France as a relatively less polluting and lower carbon-emitting country compared to other countries that are more dependent on fossil fuels. This is because of its reliance on 'cleaner' nuclear energy. This crucial fact means that it may more readily meet its 2050 net-zero carbon emissions targets. Consequently, asset-specific retrofit costs to reduce emissions may be lower in France than other countries in future years. In turn, this would mean lower future capital expenditure in asset-level return assessments. Denmark is also better placed, with over half its energy generated by renewable sources. Germany and the Netherlands compare poorly on renewable energy sources. Countries that steadily improve their levels of transparency, liquidity, and environmental standards, may become more attractive over time as their country-specific risk reduces relative to the global average.

Section 2

The RE: GlobalRiskNavigator composition



The RE: GlobalRiskNavigator composition

The above context represents just a few examples of how the changing economy and environment are leading to differentiated risks between countries. To create a better understanding of how exposure to these risks differs, we have created a methodology and an index called the **abrdrn RE: GlobalRiskNavigator** (GRN). This comprises nine datasets from our own proprietary tools or from publicly available sources. These are detailed in figure 4 below.

Figure 4: Components within the RE: GlobalRiskNavigator

Index component	Provider	Description
Real estate factors – 50% weighting		
Transparency	JLL Biennial Transparency Index	Real estate specific index, with a comprehensive assessment of each country's transparency, in terms of real estate factors. The index comprises six sub-indices (investment performance, market fundamentals, listed vehicles, regulatory and legal, transaction process, and sustainability), with 210 underlying factors across 99 countries and 163 cities.
Liquidity	MSCI/RCA Liquidity Data (Although the RCA data is quarterly, we update the data annually).	We build up our own measure of liquidity using the MSCI/RCA transactions data. The measure comprises a score built up from four equally weighted liquidity parameters based on the past 11 years of data. The parameters are average investment volumes (as a percentage of market size), volatility of flows, and peak-to-trough falls (%).
Country economic risk	Refinitiv	We have used the respective country's 10-year government bond yield as a proxy for a country's economic and financial risk. We have taken a view that the higher the country's economic and financial risk, the higher the yield that will be priced-in by investors.
Market size	MSCI annual market size Estimate	Market size is a key consideration when it comes to investing in a market. The larger the market size, the greater the variety of asset types and segments that will be available. Generally, the larger a market, the greater its level of transparency, liquidity and ability to implement a desired strategy. In the absence of a single source, we use the MSCI IPD investment market size estimate, which covers developed markets. We then augment this with the GDP method to estimate the rest of the markets.
ESG factors – 50% weighting		
Environment	The abrdrn Research Institute's Annual ESG Index	We use the development-adjusted version of the aRI ESG Index for the ESG measures. The scoring is ranked against the entire universe of 135 countries. The environment measure is based on air quality, drinking-water quality, species protection, and CO2 intensity.
Social	The abrdrn Research Institute's Annual ESG Index	The social measure encompasses labour, expected years of schooling, gender equality, life expectancy at birth, mean years of schooling, under-five mortality rates, and life satisfaction.
Governance	The abrdrn Research Institute's Annual ESG Index	The governance ranking includes free and fair elections, access to justice, freedom of expression, transparent laws, corporate social objectives (CSO) participation, absence of corruption, and social group equality.
Climate policy (transition risks)	The abrdrn Research Institute's Annual Climate Policy Index	Climate policy – this is taken from aRI's Climate Policy Index. The index only has 19 constituents at present, but we plan to increase this shortly. We have used Sweden as a proxy for the Nordics. Developed Asia is a synthetic measure and comprises 75% of the index average and Emerging Asia (also a synthetic measure) is 50% of the index average. The index includes data on greenhouse gas (GHG) emissions, renewable energy and energy use. These have a combined 50% weighting in the index and our own in-house, forward-looking climate policy assessment framework accounts for 50% of the weighting. Within the index, there are eight climate policy indicators. Each indicator is ranked between one and five. A score of one is consistent with no climate progress whatsoever. At the other extreme, a score of five is considered consistent with achieving net-zero emissions by 2050. In cases where the scoring mechanism does not explicitly specify climate targets, we consider how it fits within a net zero emissions framework.
Asset vulnerability to physical climate risk	The ND-GAIN Index	The ND-GAIN Country Index uses two decades of data across 45 indicators to rank 181 countries annually, based on their vulnerability and their readiness to successfully adapt to physical climate change risks.



Introducing the RE: GlobalRiskNavigator (GRN)

GRN is the proprietary system that we developed internally to analyse the relative level of country risk in a variety of countries worldwide. It helps to measure the two broad categories of country risk (real estate and ESG components) and then ranks countries based on how they score on factors related to these two areas.

On the real estate side, country risks include four factors: transparency, liquidity, market size, and country-specific economic risks. For ESG risks, we examine each country in the indices, based on the three separate elements of ESG. We then add climate transition and physical risks. We detail the rankings that we use and the components of the ranking in the next section.

For ESG risks, we examine the country's climate policy to quantify transition risks as countries move towards the 2050 Paris Agreement's net-zero target. Separately, we also calibrate a country's vulnerability to climate change and the impact of factors such as floods and fire may have on assets. GRN is equally weighted, with a 50% weighting for ESG factors and a 50% weighting for real estate elements. All the risk categories are shown in figure 5.

Figure 5: RE: GlobalRiskNavigator categorisation and underlying risk components are evaluated

Factor	Real estate Factors (50%)				ESG Factors (50%)				
Component	Transparency	Liquidity	Economic Risk	Market Size	Environment	Social	Governance	Climate Policy (Transition Risk)	Vulnerability to Climate Change (Physical Risk)

Source: abrdn, May 2023.

Narrowing down the potential universe

The GRN universe includes 30 countries at present and these are shown in figure 7. Most of the countries included were deemed to have sufficient depth of activity, transparency and market size to enable investors to warrant a position in the index.

We have used third-party or abrdn's proprietary data sources for each of the factors and we have ranked the countries we monitor. The abrdn Research Institute (aRI) has created various assessments of climate risk, resilience, and other ESG-related criteria across countries – and these form part of our index.

The outcome provides a view of the individual risk factors for one country relative to the others in the index, and these individual risk factors create an overall country score. The rankings for each component are given a score between one and 10, thus normalising the various data sets on which we rely. Each of the nine underlying scores are averaged on an unweighted basis, so that we have an overall score of between one and 10 for all the combined factors. In the latest update, the range for our scoring is from 2.5 to 9.4. As you would expect, and as shown in the table that follows, the more developed regions generally have the lowest overall scores (Europe and the Americas), while the APAC region has the highest risk score (see figure 6).

It is interesting to note that the risk scoring for the Americas is significantly higher (weaker) than Europe and this is down to ESG scores penalising the Americas more. Climate issues, resilience and governance around these risks all drag on the Americas more significantly. However, there is also quite a wide range within Europe. We expect this to be an ongoing situation as weather patterns evolve.

Figure 6: RE: GlobalRiskNavigator regional risk scores (within the potential range of 1 to 10)

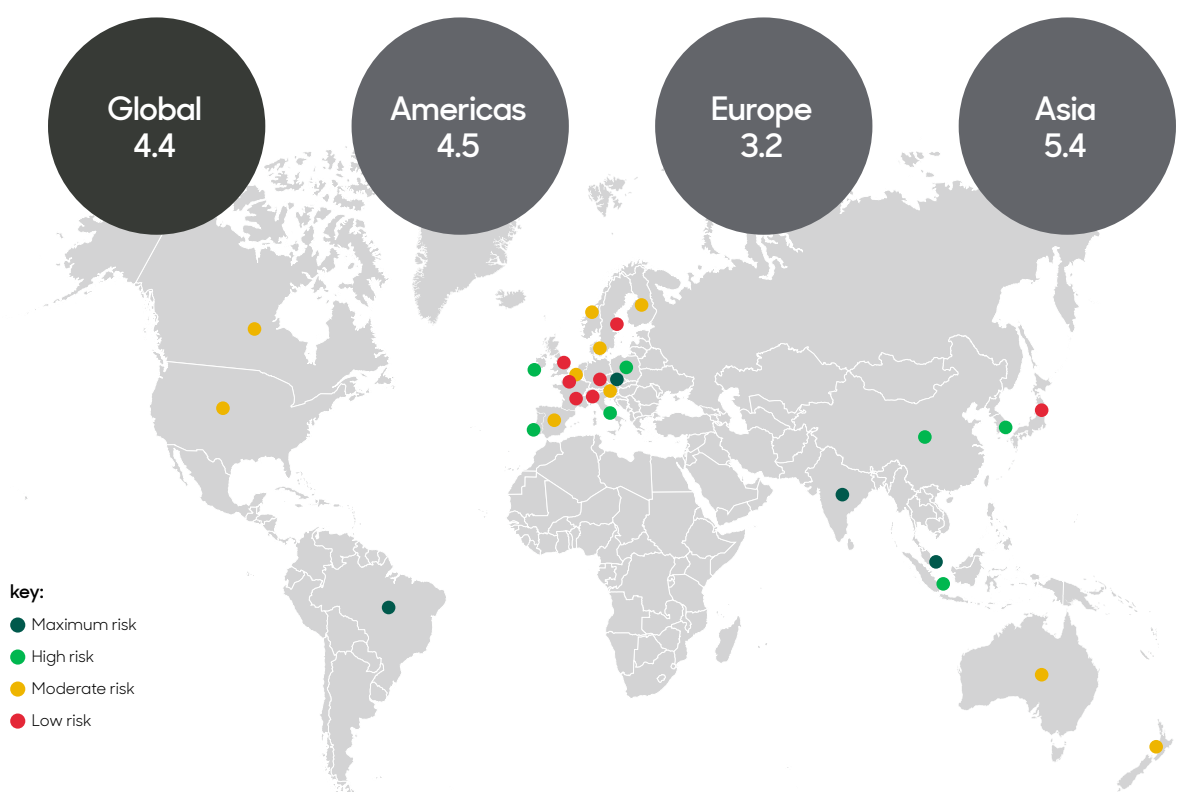
Average Risk Score (% weighted by estimated investable market size)			
Global	Europe	Americas	APAC
4.4	3.2	4.5	5.4

Source: abrdn, May 2023.

Figures 7 and 8 illustrate how investors can view the level of relative risk they are taking for an individual country compared with another. In line with the earlier regional risk scores table, it is no surprise that the most developed real estate markets – **France, Germany and the United Kingdom** – have the lowest risk scores in the universe. They have deep, liquid, well-developed real estate markets that are highly transparent. They also have firm commitments and regulatory pressures that are moving these countries to a low-carbon-emitting future, where climate change vulnerabilities are likely to be reduced.

At the other end of the scale, countries like India, Brazil and Malaysia suffer from poor liquidity, less transparency in terms of performance data, weaker market fundamentals, and fewer listed vehicles. There is also heightened economic risk and more vulnerability to climate-related risks and governance, and to social factors.

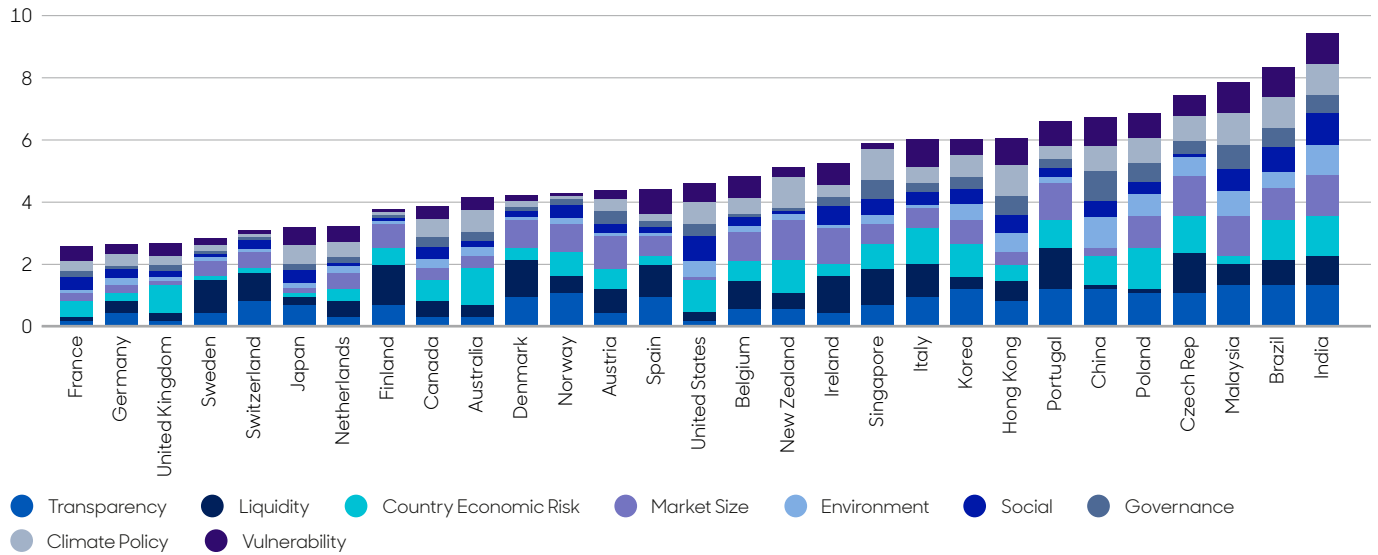
Figure 7: Global distribution of GRN scores by region and country



Maximum risk		High risk		Moderate risk		Low risk	
Country	Total GRN Score	Country	Total GRN Score	Country	Total GRN Score	Country	Total GRN Score
India	9.41	Poland	6.81	New Zealand	5.08	Netherlands	3.19
Brazil	8.32	China*	6.67	Belgium	4.79	Japan	3.17
Malaysia*	7.81	Portugal	6.55	USA	4.56	Switzerland	3.04
Czech Republic	7.41	Hong Kong*	6.04	Austria	4.36	Sweden	2.78
		Korea	5.98	Spain	4.36	UK	2.63
		Italy	5.97	Norway	4.25	Germany	2.6
		Singapore*	5.85	Denmark	4.18	France	2.54
		Ireland	5.22	Australia	4.11		
				Canada	3.82		
				Finland	3.75		

Source: abrdn, May 2023.

Figure 8: The RE: GlobalRiskNavigator Country Index

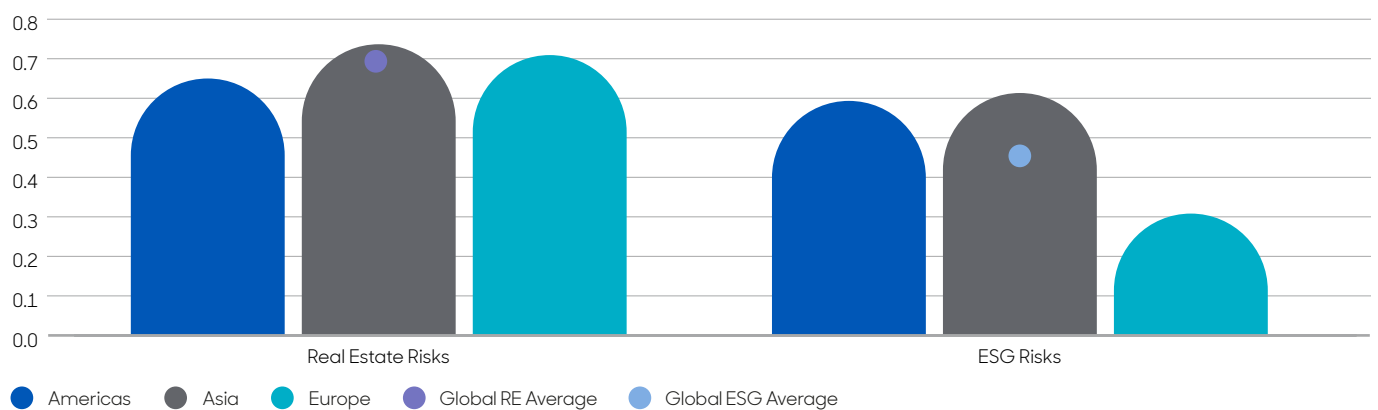


Source: abrdn, May 2023.

The key focus has to be on countries, as risks manifest themselves at this level. However, many investment mandates are regional in nature and so it is interesting to compare the higher-level risk scores to understand the wider context. In figure 9, we have aggregated the scores to regional averages and split them between real estate country-risk factors and ESG risk factors.

All regions are subject to fairly consistent levels of real estate country risks, albeit marginally lower in the US and Europe, and higher in Asia. The clear difference is in the ESG risk scores. On the ESG risk component, Europe scores far more favourably than the other regions. This is intuitive given the less extreme climatic conditions and more mature governance frameworks in place compared with Asia. Meanwhile, the Americas are polarised across different factors between the US, Canada and Brazil. Each of these countries faces very different challenges, but the cumulative effect for the Americas region is one that results in a weaker score than that for Europe.

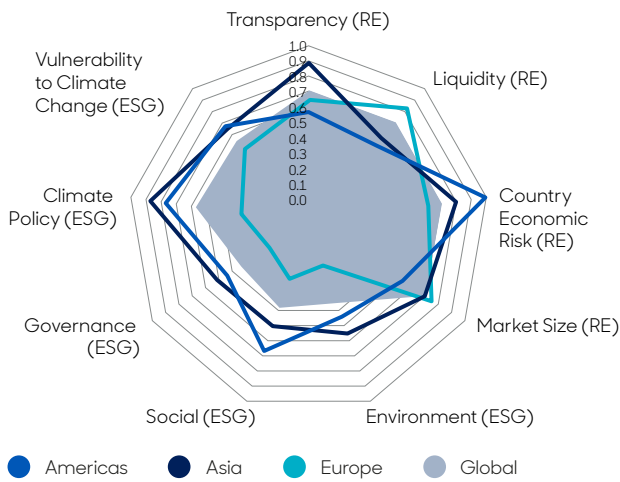
Figure 9: Regional differences in the composition of risk across real estate and ESG factors



Source: abrdn, May 2023.

In figure 10, we take a slightly more forensic approach to how each aggregated region compares. On six out of the nine measures, Europe has the lowest-risk scores in the unweighted averages. The number of small markets in the European sample means that the region scores poorly from a liquidity- and market-size perspective. The Americas score best on market size, transparency and liquidity, supported by mature US and Canadian markets. Asia has the weakest scores across four out of nine measures, including transparency, environment, governance and climate policy. These are all intuitive outcomes from our methodology, with the index clearly supporting our conviction behind these risk metrics.

Figure 10: A comparison of the regional average scores per risk component

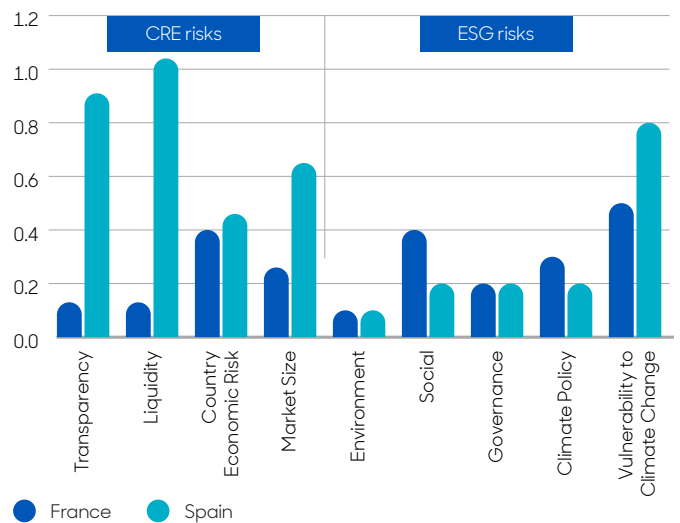
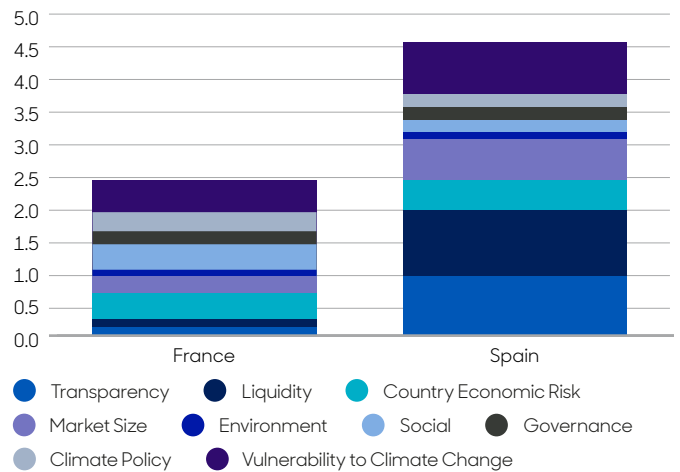


Source: abrdn, May 2023.

The rankings give investors the headlines to work with and the ability to assess overall country-risk exposure, good or bad. The finer details also help investors to be more aware of where the risks are coming from in relation to their existing holdings, acquisitions or strategies. We can take France and Spain as an example, as shown in figure 11. Spain is mid-ranking within the global index, while France currently tops our index. While both countries are in the EU, are geographically neighbouring and share many similarities, there are significant differences in their risk levels and components. The big differences are in the market transparency, size and liquidity scores, where France comes out on top. Spain is also negatively affected by a poor score for climate resilience, which seems rational in view of the ongoing desertification taking place

across large parts of the country. France’s comparative weak point is on social-risk factors. This also appears rational given the propensity for the labour force to take action and to oppose reforms. The recent unrest following the proposal of an increase in the retirement age for public workers to 64, up from 62, is a good example.

Figure 11: Comparing France and Spain



Source: abrdn, May 2023.

The section that follows examines how the RE: GlobalRiskNavigator can be used in practice. The outcome will depend on an investor’s risk appetite to construct portfolios that meet their risk tolerance, using real world examples.

Section 3

How can we use this tool to enhance our investment strategy?



How can we use this tool to enhance our investment strategy?

This dataset, and its simple and robust methodology, provides a basis for considering how funds and strategies are structured against this backdrop. Not only does the GRN give us unique context, it also provides us with information that helps tactical and timely investment decisions.

As we described at the start of the paper, market allocation decisions drive an estimated 50% of relative performance. Managing our exposure to country-level risks should help us to execute strategies successfully. **The index gives us a greater degree of clarity around whether the performance we are achieving reflects the true risks that are being taken.** Lastly, but most importantly, it tells us if future performance is at risk and it signals whether we need to change allocations accordingly.

In the previous section, we cover how each region compares in the index. In terms of institutional capital, we can evaluate the risk of real allocations. MSCI collects data on real estate funds globally and we have used the Global Property Funds Index (GPFI) to evaluate country-risk exposure across multi-country, institutional investors' portfolios.

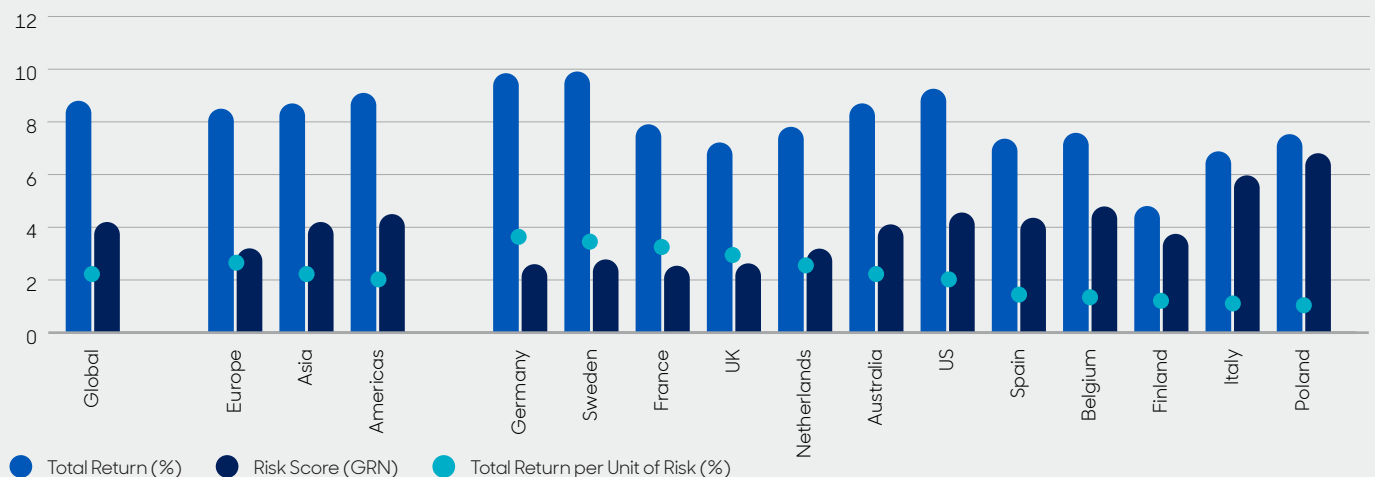
The second phase of our analysis considered how actual portfolios are exposed from a country-risk perspective. Overall, global property funds have a lower-risk exposure than the estimated universe outlined in section 2. When weighted to the gross value of the GPFI index, there is a total country-risk exposure of 4.2, compared with 4.4 for the wider market. The most notable regional difference to the weighted universe is in Asia-Pacific, where fund exposure to country risk comes in at 4.2 compared with the market level risk of 5.4 in Asia. This is largely a result

of just \$3 billion of gross value invested in China, and no allocations to India and Malaysia in the sample – three of the higher-risk markets in Asia.

Introducing historic returns into the analysis, we looked at the property-level performance of institutional investment performance globally. Combining 10-year annualised returns and the weighted risk scores shows that the return per unit of country risk is relatively similar across regions. Generally speaking, where returns have been higher, country risk is higher; and where returns are lower, country risk is lower.

Globally, real estate in the MSCI GPFI has returned 8.8% per annum over the last 10 years at a weighted risk exposure of 4.2, according to our index. That's roughly a 2.1% return per unit of GRN country risk. The Americas have the lowest return per unit of risk at 2%, Asia is 2.1%, and Europe leads with a return of 2.7% per unit of risk. Europe was the weakest performing region in the sample over the 10-year period when it comes to total returns, but comes out favourably in the risk-adjusted perspective given the materially lower GRN risk scores in these markets. At the country level, Germany, Sweden and France delivered the best risk-adjusted returns at 3.8%, 3.6% and 3.1% of return per unit of country risk, respectively. The breakdown is shown in Figure 12.

Figure 12: Ten-year annualised total returns per unit of risk (%)

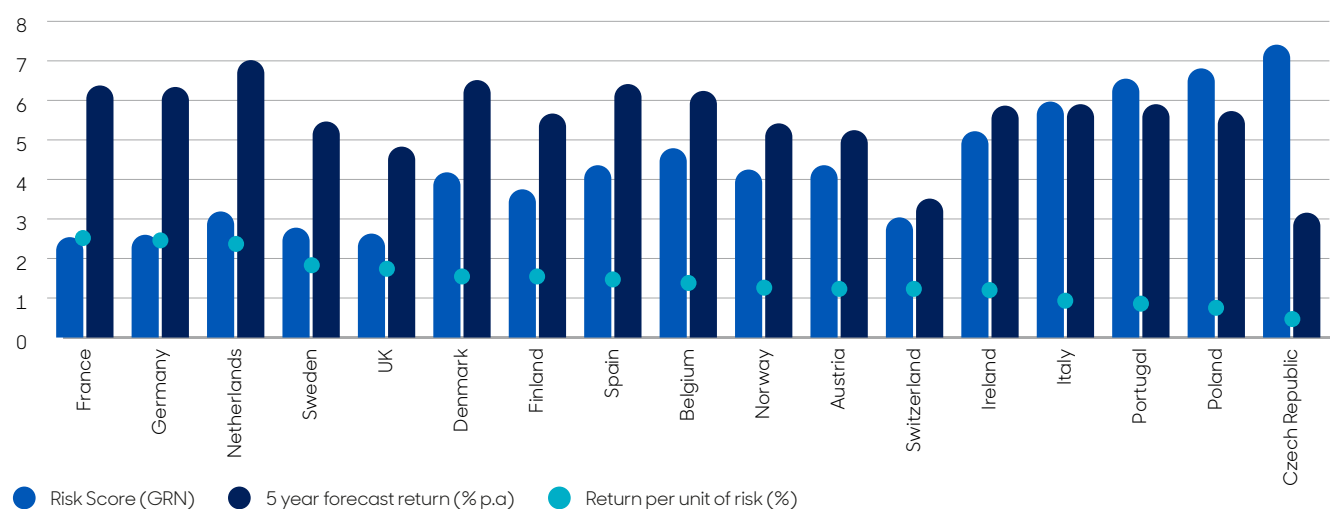


Source: MSCI GPFI Index, abrdrn, May 2023.



But how can we start to use this to help make decisions? By placing a limit on risk exposure, it is possible to see how limiting market exposure to only those countries with below-average risk scores could influence returns, at least at the market level. By capping market risk at the unweighted average of five and only investing in markets below that risk level, the overall historic return per unit of risk rises to 2.9%, compared with 2.1% for the full GPF sample. Therefore, by limiting market risk, the risk-adjusted return can be enhanced. The average total return of GPF markets with a risk score below 4.2 is 7.9%, which is nearly 1% per annum below the global average through the period. However, the average country-risk exposure is 2.9, compared with 4.2 for the sample. So essentially, a relatively small amount of return has been sacrificed, but is more than compensated for by the lower risk exposure.

Figure 13: Forecast total returns versus country risk scores: Europe

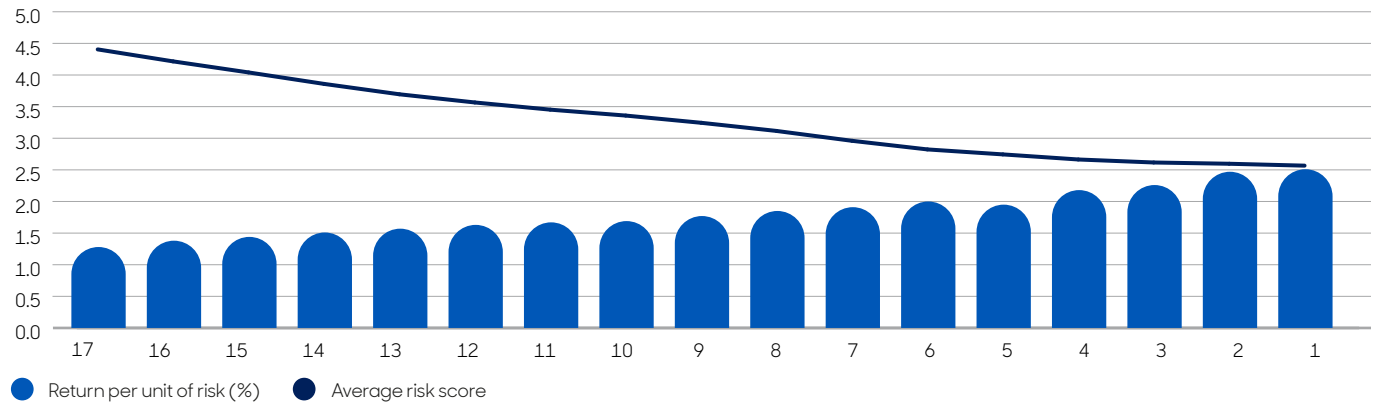


Source: abrdn, May 2023.

Finally, we can consider how we can use this tool in a strategic way to help our funds achieve the best possible structure or allocation scores in the long term. We forecast market level returns for over 200 segments globally. By applying a country-risk filter to our forecasts, we can assess where the best market returns could be achieved through a country-risk lens. We can point our strategies towards markets where achieving their objectives has the highest chance of successful implementation. The aim is not always to identify the lowest-risk markets, but to identify when the market cycle is starting to offer better value for investors in more risky markets, too.

Most of our international strategies are pan-European in nature, so we have used this region as an example. Figure 13 shows abrdn's five-year annualised forecast total returns across our European market as of March 2023, ranked by the return per unit of GRN country risk. The overall forecast return for Europe and the UK over the next five years is 5.1% per annum. Taking an unconstrained approach to the risk scores (assuming the hypothetical mandate doesn't align to the underlying market sizes), the European unweighted average risk score is estimated at 4.4. By capping the market risk at the mean risk level and by only investing in markets ranked below this level, the return per unit of country risk increases from 1.2% to 1.7% per unit of risk. In this case, the actual return expectations for the lower-risk markets are higher too (5.7% per annum, compared with 5.1% for the whole sample), given the current weaker outlook for the higher-risk markets of Central Europe, in particular. **France, Germany and the Netherlands offer the strongest forecast returns per unit of risk at 2.5%, 2.4% and 2.2%, respectively. The weakest performers are the Czech Republic, Poland and Portugal.** Figure 14 shows how the return per unit of risk improves as the sample size gradually becomes more constrained towards the lower-risk markets.

Figure 14: Average return per unit of risk increases as allocation to lower-risk markets increases



Source: abrdn, May 2023.

Europe and UK, risk tolerance set at 4.4

Countries included	Austria	Denmark	Finland	France	Germany	Netherlands	Norway	Spain	Sweden	Switzerland	UK
Countries excluded	Belgium	Czech Republic	Ireland	Italy	Luxembourg	Poland	Portugal				

We have run this analysis on various portfolios, setting the risk cap in accordance with the risk tolerance of each mandate. For core mandates, we have typically set a comparable 'investible universe' that includes markets at the lower end of the risk spectrum. For value-add strategies, the risk tolerance is set higher. While the output is never prescriptive, the results shine a light on allocations that simply don't make sense – both from an overweight and underweight perspective. Managers can carry good and bad market biases. **This tool helps investors to check if portfolios sit in the most appropriate parts of the market in order to achieve the best outcome for their clients.** Risks change over time, especially when considering climate change and other ESG factors. Running this exercise on a frequent basis gives managers the chance to ensure portfolio allocations remain appropriate and aligned to the risk budgets in funds.

Conclusions

The number one rule of investing is diversification. **By spreading risk across different factors, such as through carefully considered country allocations, an investor can significantly enhance risk-adjusted returns.** However, we also strongly believe that this risk taking must be measured and consistently applied. Country allocation is a risk decision, regardless of how many countries an investor is exposed to, and we advocate for a more informed approach to this important risk factor.

We believe that our proprietary index can offer investment strategies greater insight into the risks inherent in each country allocation. While these risks are well established from a real estate perspective (transparency, liquidity and economic risk), the ESG risks that we now incorporate are perhaps the newest and most controversial amendments to our framework. Given that our index is designed to guide how likely a strategy can be successfully implemented over a five- to seven-year period, the inclusion of factors such as climate change and climate resilience are an important step. With 2030 targets for energy performance certification now within that investment timeline, the costs and potential issues around attaining the necessary accreditations are a real risk today.

We have demonstrated that by using the tool to sense-check and inform existing and future allocations, better outcomes could be achieved by investors. Of course, we recognise that this is just one component of overall risk-profiling when it comes to underwriting strategies and specific asset risks, and it purposefully ignores volatility. But when it is used alongside other tools for managing property risks, and with expert investment management experience, we believe investors can be better placed to make more informed choices and to generate good performance over the long term by using this tool.

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