Risk Reduction: Invest in Uncorrelated Markets

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Most people, including real estate investors who are seemingly aggressive, are **risk-adverse**. For instance, say there are 2 investment projects that offer potential returns of 100% and 60% respectively, investors are likely to be interested more in the higher-return project. Now, say the higher-return one (100%) carries a risk factor of 60% while the lower-return one (60%) carries a risk factor of 20%, then some if not all will have second thoughts as to whether they would like to pursue the higher-return project still. Part of the reason being that the higher-return project has a **return to risk ratio** of 1.66 (100/60) while the lower-return project offers a ratio of 3.00 (60/20), i.e. the lower-return project provides a higher return per unit of risk assumed. Obviously the foregoing figures are arbitrary but they should be sufficient to illustrate the point.

It is often said that diversification is one way to reduce the risks. While this has served many quite well in the past, **diversification alone may not be sufficient to meet future investment challenges**. Let' s look at what diversification in real estate terms may traditionally mean:

a) <u>Investing in different real estate market sectors</u> (or even sub-sectors) = e.g. by investing in 2 or more of the sectors such as residences, offices, retail complexes, industrial facilities, and so on.
b) <u>Investing in different geographical locations</u> = these could mean investing in different continents, different countries, different cities or different districts in a city.
c) <u>Investing in different real estate product types</u> = while real estate can be purchased ' direct' (equity side), investors may also consider buying the mortgages and securities springing from such mortgages (debt side).
d) <u>A combination</u> of the above.

The above list is by no means exhaustive and there may be other ways to diversify too. Nonetheless, irrespective of one' s diversification preferences and expectations of return and risk parameters, one way to help reduce and manage the risks is to invest in markets (cities, sectors, products etc) which are **NOT highly correlated**, either positively or negatively, to one another. Suppose there are 2 markets A and B. Positive correlation in terms of price trends etc implies that when A goes up, do does B and vice versa = adding B to A reduces no risks inherent in A = the portfolio has more or less the same risk characteristics as when A is used alone. Negative correlation implies when A goes up, B goes down and vice versa = the returns are neutralized while the risks have not really been reduced much. Investing in uncorrelated markets provides an opportunity to earn a higher return at each level of risk, or putting it in another way, to reduce risk for a given level of return, assuming each of the markets has a reasonable return to risk profile. Will this lead to a portfolio mix which gives a lower return than the one originally conceived?

Possibly, because the ‘ originally conceived’ portfolio may NOT have taken risks into serious consideration. The challenge is to find enough of such uncorrelated markets to invest in given the potential effects of globalization that tends to increase the likelihood of market symmetries. **Don’ t think just because one’ s portfolio is spread all over the region or spectrum that one has really reaped the benefits of diversification** (which is meant to reduce risks).

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