Commercial real estate: Building blocks for portfolio growth and diversification

Unpredictable volatility in equity markets and persistently low interest rates continue to challenge investors looking for better returns. As a result, alternative investment products may be an attractive option. One asset class that has prospered over the last decade is commercial real estate. As part of a portfolio strategy, commercial real estate can act as a buffer against stock market volatility. As well, it offers benefits like leverage, tax deductions, market appreciation potential and cash flow.

"We believe real asset investments like real estate and infrastructure offer an interesting combination of stable cash flows over the long term and growth that is generally in line with inflation," said Craig Noble, Chief Investment Officer at Brookfield Asset Management's Public Securities Group. "Investing in real assets has the potential to generate a good level of current income."

Here are some of the investment strategies that can help you take advantage of owning commercial property, both directly and indirectly.

The direct approach

Commercial real estate typically refers to income-producing properties, including office, retail, industrial/warehouse, hotel and rental apartment properties. It also includes sub-segments like self-storage, manufactured housing and private health care facilities.

There are two ways to earn a profit on a commercial real property. The first is to sell a property for more than you paid in order to generate a capital gain. The other, more popular way to earn money is to charge business owners a lease to use the space. This lease rate is a monthly or annual rental rate based on a per-square-foot cost. Lease contracts with commercial tenants tend to be longer than those with residential tenants. As a result, commercial property holdings can offer cash flow stability.

There are also tax benefits to owning real property. Mortgage interest, maintenance expenses and depreciation are all tax deductions that can help shield a large portion of your income stream.

Keep in mind that direct investment in commercial property requires a much larger down payment, often 30% or more of the property's purchase price. Also, commercial mortgage rates are typically higher than residential mortgages. Tenant turnover can also be costly since commercial property owners must renovate a business unit to accommodate each tenant's specialized trade.

The indirect approach

If you're not interested in managing real property, several investment options exist that offer exposure to commercial real property. These include real estate investment trusts (REITs), securities, operating companies, pooled funds and mortgages.

By purchasing shares in a REIT or units in a real estate pooled fund, you're investing in a company that owns and manages real estate on behalf of its shareholders. Since this type of market exposure is indirect, you're paid a dividend or distribution, rather than rent. Any price appreciation or depreciation in the company's assets is reflected in the share price.

Different strategies, different goals

Investing in REITs: Generally, there are three main types of REITs that can be both publicly traded and privately operated.

- Equity REITs, which own and operate hard real estate assets
- Mortgage REITs, which trade commercial and residential mortgages
- Hybrid REITs, which are a combination of equity and mortgage REITs

One advantage of owning REITs is that the underlying assets are real property, so you have maximum exposure to real estate without the hassle of having to manage properties yourself. Also, by holding a number of properties, REITs offer diversification that may help enhance returns and reduce your risk. REITs also feature lower entry costs to the commercial property market. Finally, REITs must distribute at least 90% of their taxable income annually in the form of dividends (taxed at a lower rate than ordinary income).

Investing in pooled funds: Investing in real estate is trending toward greater levels of specialization. This shift may mean a more specific asset class focus, a more exclusive focus, or both. Investing in private real estate funds offers the benefits of diversification and the reward of professional portfolio management. These funds pool the capital of multiple investors and follow the fund manager's investment strategy. Although similar to traditional mutual funds in structure and other key characteristics, pooled funds are different because they are designed primarily for affluent investors seeking more sophisticated strategies. Pooled funds have higher minimum investment levels as well as reduced management fees, and typically have more flexibility than mutual funds to employ alternative investment strategies and provide access to specialty sectors and products like real assets. The chief objectives of a real estate pooled fund are usually to seek long-term capital growth and income flow.

Other options: Index-based products like exchange-traded funds and mutual funds that track property and REIT benchmarks provide diversification and transparency of holdings. While these funds often follow equity market cycles, they do provide liquidity and easy access to real estate assets. You may also want to look outside of Canada and consider global property markets.

It's important to consider how various investment products will affect your investment portfolio, and we can help you with that. If you have questions about the potential benefits of commercial real estate investments, please give us a call.

Clients are advised to seek advice regarding their particular circumstances from their personal tax and legal advisors.

Foreign currencies: An overlooked asset class

Holding foreign currencies such as the U.S. dollar, Japanese yen or the euro in your registered[1] and non-registered accounts can offer you additional investing opportunities. Consider the following tips on how your portfolio can potentially benefit.

Extra diversification

Bonds, equities and cash are not the only investment options. Did you know that the currency/foreign exchange (FX) market is the largest and most liquid market worldwide? However, it's often overlooked by Canadian investors. As an asset class, holding currencies in your portfolio can add extra portfolio diversification as it tends to behave differently compared to equity and fixed income returns.

What to hold? When to convert?

Given fluctuating exchange rates and conversion fees, converting foreign currencies into Canadian dollars can be costly. Currency forecasting is difficult…maybe even more difficult than stock forecasting. In the short term, currency values can be influenced by macroeconomic events. For example, both the Swiss franc and the Japanese yen benefited from 'flight to safety' trades during the 2008 global financial crisis. The Canadian dollar declined about 25% versus the Swiss franc and about 35% versus the Japanese yen during this period.

Luc de la Durantaye, Managing Director, Asset Allocation and Currency Management, CIBC Asset Management, has analyzed the impact of volatile currencies on portfolio returns and it can be substantial. "It's tempting to assume that, over an extended time frame, the home currency will rise in some periods, fall during other periods, producing a 'zero sum' effect overall. In reality, that's rarely the case," says de la Durantaye. Currencies move in trends, and those trends may extend over a number of years. For Canadian investors, during the years 2006 to 2016[2], global foreign currency exposure added almost 2.8% (annualized) to portfolio returns.[3]

How to indirectly invest in foreign currency

You can also participate in the foreign currency market indirectly by investing in foreign equity markets across the world. With many key U.S. stock indexes near record highs, you may want to consider other geographic regions. "If you look at the U.S. as an alternative, there's potential, but the equity market is already quite expensive, so potential returns are limited," says Vincent Lépine, Vice-President, Global Economic Strategy, Asset Allocation and Currency Management, CIBC Asset Management.

Investing in foreign bonds is another way to diversify portfolios. With historically low interest rates in the U.S., investors may want to consider turning to other regions that have higher interest rates, and potentially higher bond yields. "Emerging markets are one alternative," Lépine suggests. "It's not just emerging market equities; it's also emerging bond markets. The challenge is finding the right market."

Minimize conversion fees and convert when you choose

In addition to the benefits of portfolio diversification, consider these three scenarios[4] which illustrate how foreign currencies can be held strategically or conveniently in a registered account.

- Richard works in Canada for a U.S. company and is paid in U.S. dollars. He can contribute that income to a registered account without incurring conversion fees.

  When the RRSP is eventually converted to a RRIF, his holdings can remain in the foreign currency. RRIF withdrawals in U.S. dollars are particularly valuable for Canadians who move to or travel frequently to the United States.

- Lisa has amassed some fairly sizable savings in euros from a teaching job in Italy. She would like to diversify her retirement portfolio and save currency conversion fees. By contributing the euros directly to her RRSP, she avoids incurring the foreign exchange fees.

- In December, Audrey receives an inheritance in British pounds and wants to top up her RRSP in the next two months. She does not believe this is a good time to convert British pounds to Canadian dollars. By contributing the British currency to her RRSP, she strategically holds it and works with her advisor to identify a more favourable time to convert.

When the need or desire to convert a currency arises, we can tap into our experts' insights at CIBC Asset Management—one of the largest currency managers in North America.

Please contact us to discuss how holding foreign currencies can help to diversify your investment portfolio. To find out which foreign currencies you can hold in your account, visit CIBC Wood Gundy Online.

1 Except Registered Education Savings Plans (RESP).

2 As at June 30, 2016.

3 CIBC Asset Management calculations. This assumes that the typical Canadian investor holds the global equities of the MSCI All Country World Index, unhedged. The currency return is calculated as the difference between the hedged and unhedged returns to that index.

4 For illustrative purposes only.

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