International diversification can substantially reduce the risk of a real estate portfolio. Investors who want to implement an international real estate diversification strategy have two possibilities: they can invest directly, by buying actual buildings, and they can invest indirectly, by buying the shares of listed property companies. In the 1980s and before, international real estate investors were forced to opt for the former since the size of the global indirect property market was just too small to absorb substantial amounts of capital. Since then, a global market for property shares has developed which currently has a total market value of about 350 billion US dollars. This enables international investors to take the indirect route.

The purpose of this study is to find out whether an international investor should buy foreign properties directly or indirectly. Information on the performance of the direct investment strategy can be obtained by studying property companies which have the bulk of their real estate assets outside of their own country. These companies own an international direct property portfolio, and their returns therefore reflect the performance of the direct strategy. Worldwide, there are some 36 listed property companies of that kind. To compare their performance against those of indirect real estate portfolios, one has to construct performance indices of locally operating real estate companies. Of all the listed property companies in the world, some 330 are of a local nature and invest only in real estate in their own country.

We expect an indirect international real estate investment strategy to be most effective for the following reason. Since it is likely that private information will be incorporated more slowly into asset prices than public information, it may be possible to beat the real estate market consistently by using private information. However, there is no upside without a downside, and if some investors can consistently beat the market, there must also be investors who are consistently outperformed by it. The market is just an average, and if there are outperformers, there must also be underperformers. In the case of direct real estate, the underperformers are probably those lacking the private information. They will pay too much and receive too little for their properties, and will generally end up with more lemons than the informed investors.

Indeed, as this paper shows, direct investment in foreign property gives a worse risk-adjusted return than indirect international property investment. The aggregate index of all the
international property companies in our sample increases from 100 in 1984 to 252 in 1995, whereas a mimicking index of locally operating property companies, with the same overall portfolio weights, increases from 100 in 1984 to 348 in 1995. This translates into average annual returns of 7.7 percent for the internationals and 10.4 percent for the locals. The difference of 2.7 percent return per year is an indication for the cost of international diversification in non-public markets. This result suggests that international diversification is not a free lunch in private markets. As we expected, overcoming international barriers, getting local contacts and collecting information in a foreign country turns out to be more expensive in the private real estate markets than in the public real estate securities markets.

This means that international investment in real estate should be done indirectly through locally operating real estate companies. Institutional and private investors who want to build up international real estate exposure should buy the shares of domestic real estate investment companies at foreign stock markets. This is the easiest and cheapest way to reduce the cost of international real estate investment, and to use the private information local players have. By the same token, for investments in their own domestic market property investors can still invest directly and benefit from the information advantage they have there.

Based on our empirical results, we see a bright future for mutual funds investing in the global real estate securities market. They can offer individual investors the same kind of service now offered by international property companies: diversified real estate portfolios, reduction of transaction costs, and convenience. Furthermore, they do that without the information costs the international property companies incur.

In short, our results indicate that an optimal real estate investment strategy is to invest directly at home and indirectly abroad.