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Did Market Liquidity Impact Real Estate Returns?

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- Using RCA Capital Liquidity Scores® and MSCI total returns, we evaluated the performance of 83 global real estate markets between 2011 and 2020.
- We found a positive correlation between liquidity scores and total returns during the analysis period, suggesting investors seeking an illiquidity premium in less-liquid markets may not have found one.
- Lower liquidity volatility may also have benefited investors as markets with higher and more stable liquidity scores outperformed those with higher but more volatile scores.

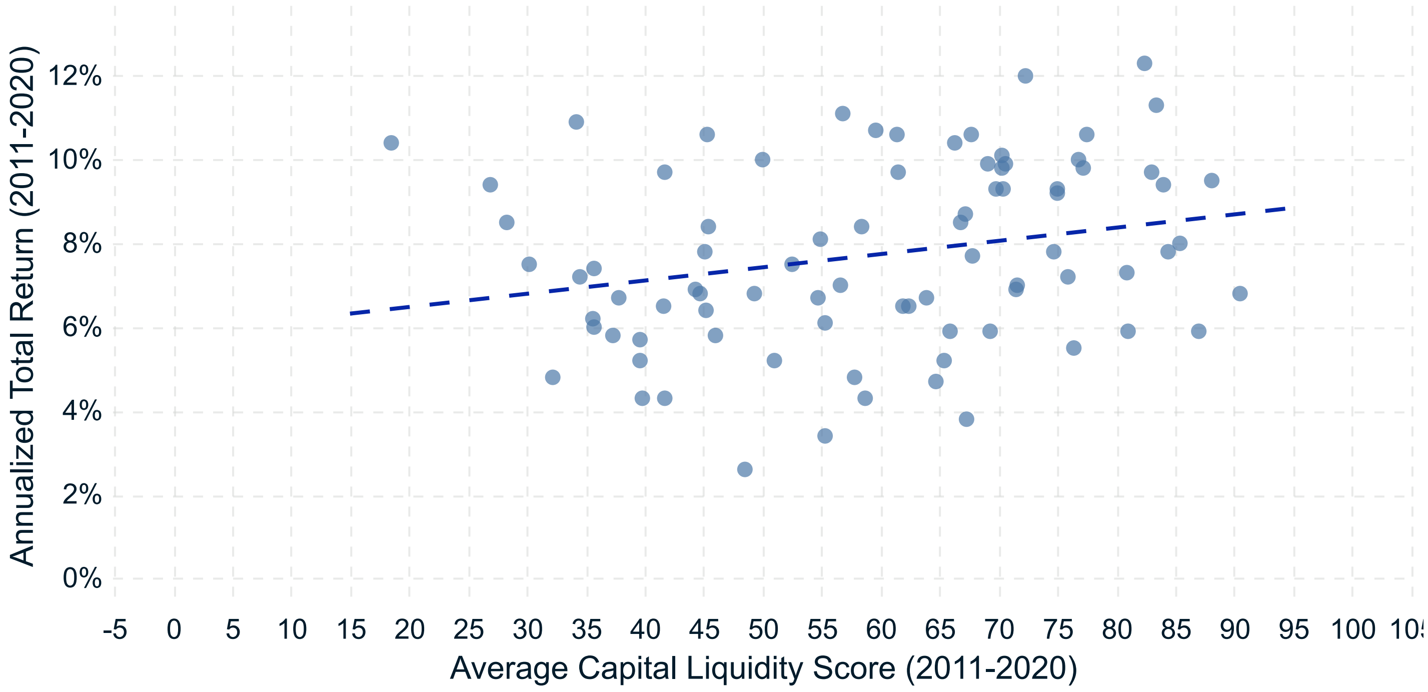
Real estate is an illiquid asset class, with long transaction times, significant transaction costs, long hold periods and limited turnover of heterogeneous assets. Within the asset class, liquidity can also vary considerably between different assets, markets and time periods. Therefore, it may be pertinent to ask whether differences in liquidity within real estate have had an impact on investment returns.

To do this, we compared the total-return performance of 83 global real estate markets against RCA Capital Liquidity Scores® over the 10-year period between 2011 and 2020.[1] We found a positive correlation between liquidity scores and total returns, and markets with higher and more stable liquidity scores achieved higher returns on average.

Comparing liquidity and total returns

RCA Capital Liquidity Scores measure the depth and breadth of capital active in global real estate markets, aiding property investors, financiers and advisers who need to understand market liquidity for risk management and portfolio allocation.[2] Comparing the average liquidity score over the last decade to total returns from the MSCI Global Property Index, we found a positive correlation (0.25), suggesting that more-liquid markets outperformed less-liquid ones.[3]

Total returns were correlated with liquidity scores during the last decade

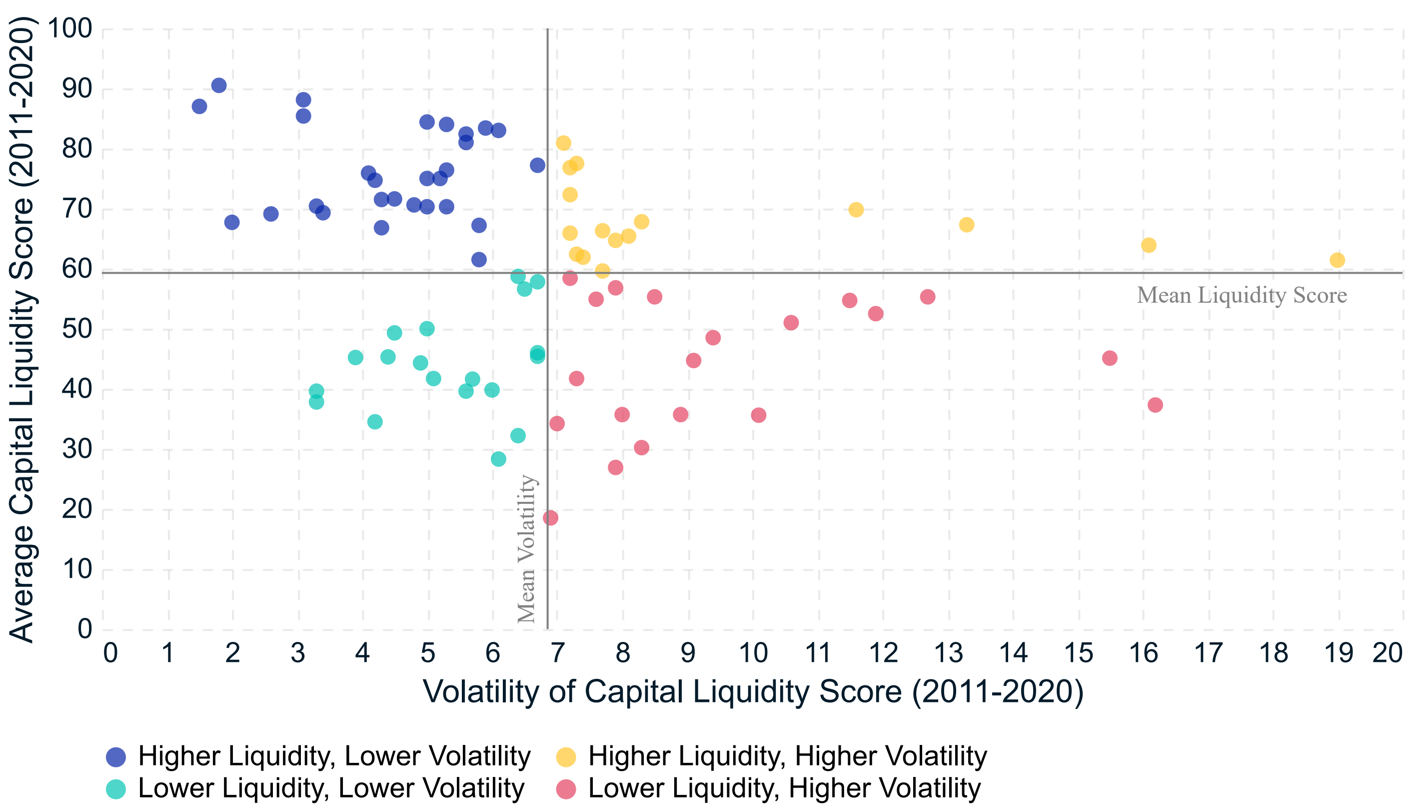


In theory, one might expect an illiquidity premium to compensate for higher liquidity risk. Therefore, these results may surprise some investors and mean that those who sought an illiquidity premium in less-liquid markets during this period may not have found one.

Incorporating the stability of liquidity scores

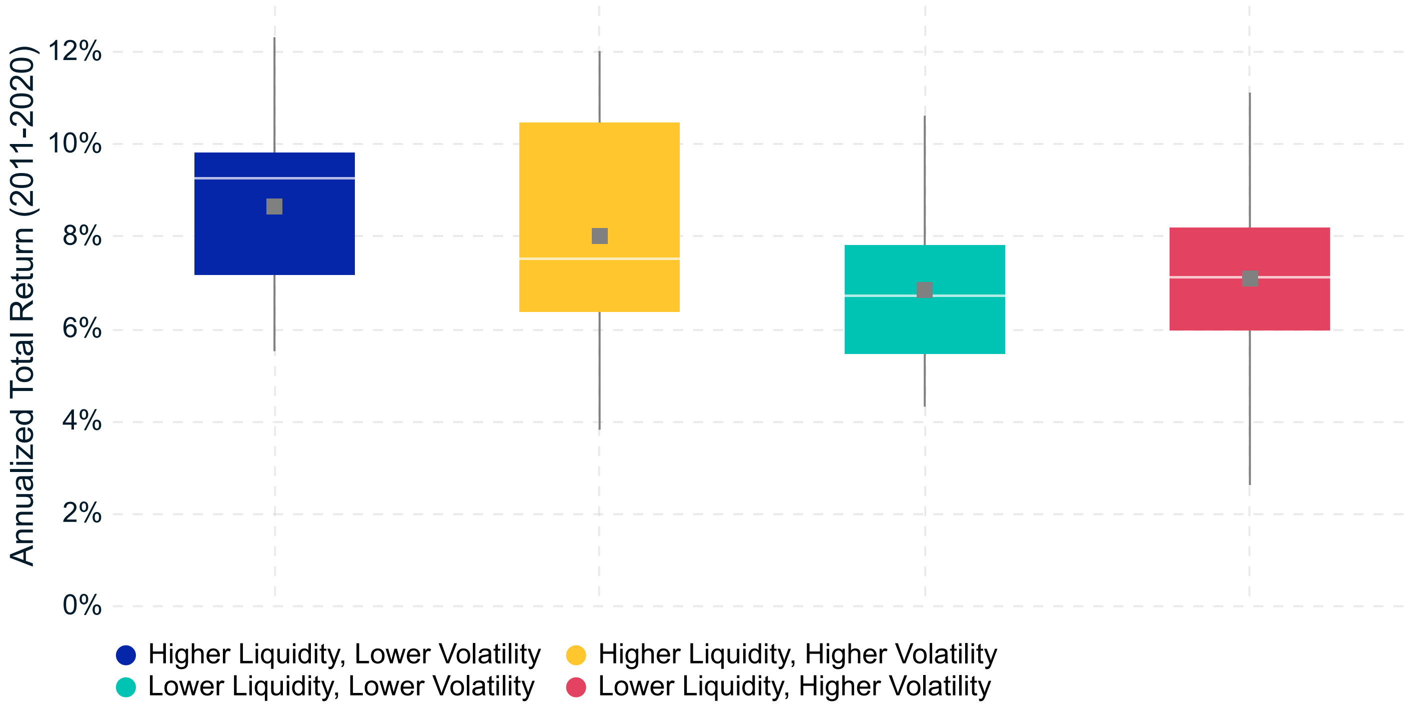
In addition to the average liquidity score, the stability of liquidity in a market may also be an important consideration for investors. For instance, some smaller markets may have a high average liquidity score driven by brief periods of higher liquidity. In the chart below, we show the relationship between the average liquidity score of the 83 markets and the standard deviation of those liquidity scores.

Some liquidity scores were more stable than others



Looking at the total returns of markets in each quadrant of the exhibit above, we see that those in the top left — with higher and more stable liquidity — performed best, with an average total return of 8.6% compared to an average across all 83 markets of 7.7%. Markets with higher liquidity but higher volatility (top-right quadrant) also outperformed on average, but to a lesser extent, with an average total return of 8.0%. Those with relatively low and stable liquidity scores (in the lower left) achieved the lowest average total return at 6.8%. While markets with lower, and higher-volatility, liquidity (lower right) achieved an average total return of 7.1%, but also had the widest range of returns.

Higher and more-stable liquidity scores were linked to higher average returns



Boxes represent interquartile range, while whiskers show minimum and maximum values.

Correlation does not imply causation

Liquidity is undoubtedly an important consideration for many investors, but its systematic impact on investment performance is still not well understood. In our analysis we found a positive correlation between market liquidity and total returns, but there was also considerable unexplained variation — meaning that liquidity scores were only a weak predictor of total return.[4] Additionally, it should be stressed that the positive correlation does not mean higher liquidity drove higher total returns. For example, it is possible that better-performing markets attract more capital and therefore become more liquid. That said, these results are an important first step toward better understanding the relationship between market liquidity and real estate investment returns.

[1]In September 2021, MSCI acquired Real Capital Analytics, provider of RCA Capital Liquidity Scores.

[2]The six measures used to calculate RCA Capital Liquidity Scores and their weightings are volume (25%), number of unique buyers (25%), percentage share of global cross-border investment (20%), percentage share of zone market-maker investment (15%), percentage share of institutional investment (10%) and percentage share of global market-maker investment (5%).

[3]Controlling for differences in performance across national markets and looking at trends within countries, we found similar results.

[4]The R-squared of a bivariate regression was 0.06.

Further Reading

[RCA Launches Capital Liquidity Scores for Commercial Real Estate]

[Global gateway cities: the performance behind the hype]

[Could Factors Help Explain Asset-Level Real Estate Performance?]

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