How polarisation in the Dutch office market creates opportunities for strategic asset allocation

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Introduction

Office polarisation is growing and more relevant than ever. It presents both challenges and opportunities for investment strategies. This paper, the first in a trilogy, aims to delve into several aspects of this topic, identifying important drivers for strategic asset allocation and delving into risk-adjusted return measures. Then it will be explained how office polarisation is not only a challenge, but also creates investment opportunities. Office polarisation refers to the growing divide between prime office locations that have high occupier demand and secondary locations that struggle to maintain occupancy. This divide is driven by various factors, including economic shifts, technological advancements, and changing employee preferences.

The second paper will delve deeper into distinguishing winning from losing locations, while the third paper will focus on distinguishing winning from losing assets. Our research, motivated by the need to understand the complexities of office polarisation, seeks to provide actionable insights for stakeholders. Through this trilogy, we aim to equip businesses, investors, and policymakers with the knowledge and strategies needed to navigate the future of office spaces.

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Key takeaways

1. Prioritizing risk-adjusted returns is key to building a resilient strategic asset allocation.
2. The historical risk/return spread between the Dutch office benchmark and the top-performing quartile is significant – and growing.
3. The continued divergence in office market performance presents an opportunity for thoughtful strategic asset allocation.

Our upcoming research will dive into which Dutch office locations and assets will win in this polarising market.

The importance of risk-adjusted return in strategic asset allocation

When setting their target allocations, institutional investors typically look at a variety of factors, such as liquidity, correlations, solvency ratios, ESG drivers and impact investments. Ideally, the distribution of asset classes should align with their liabilities and risk tolerance, with risk-adjusted return measures playing a key role in their calculations.

In addition to liquidity and solvency, certain other measures may be prioritized, depending on the investor's goals. For example, those wishing to maximise the financial and social return/risk ratio while retaining minimum capital will place more weight on return on capital. However, profitability is a more helpful indicator when taxes are incorporated into financial calculations and capital requirements are matched. Insurance companies calculate capital requirements under the Standard Formula approach in Solvency II by aggregating market, underwriting, counterparty default and operational risk.

Including assets with low or negatively correlating returns can help create diversification in a portfolio. Tail risk analysis modelling (e.g., 1-in-200 events) can produce different risk outcomes compared to volatility-only calculations. Pension funds often favour optimising the coverage ratio. They may decide to enhance return stability or increase returns by tilting their strategic asset allocation based on, for example, the dependency ratio, ESG drivers and other impact ambitions and contribution levels.

When it comes to real estate, returns and volatility typically fall somewhere between those of bonds and equities. The Sharpe ratio (a return-risk ratio), cash returns and dividends are relatively high, and rental contracts are generally CPI-linked. Still, liquidity tends to be low compared to bonds and equities.

An increasing divergence in risk-adjusted returns between Dutch office segments

The ideal portfolio, according to Markowitz's Modern Portfolio Theory (MPT), is assembled based on a variety of measures such as expected return, expected volatility, correlations and target allocations. Let us use that theory to shine a new light on Dutch real estate allocation by accounting for office market polarisation in the risk-adjusted return measures.

In the Netherlands, the growing office demand polarisation highlights the clear divide between winning and losing office locations and assets in strategic asset allocation. This is evident not only in the marked divergence between the total office benchmark and the 75% percentile, but also when comparing performance differences across office segments with those in other sectors. To illustrate this justified distinction, we will compare the historical risk/return profile of the four major Dutch real estate sectors: residential, retail, industrial and offices.

Comparing risk and volatility in major Dutch real estate sectors

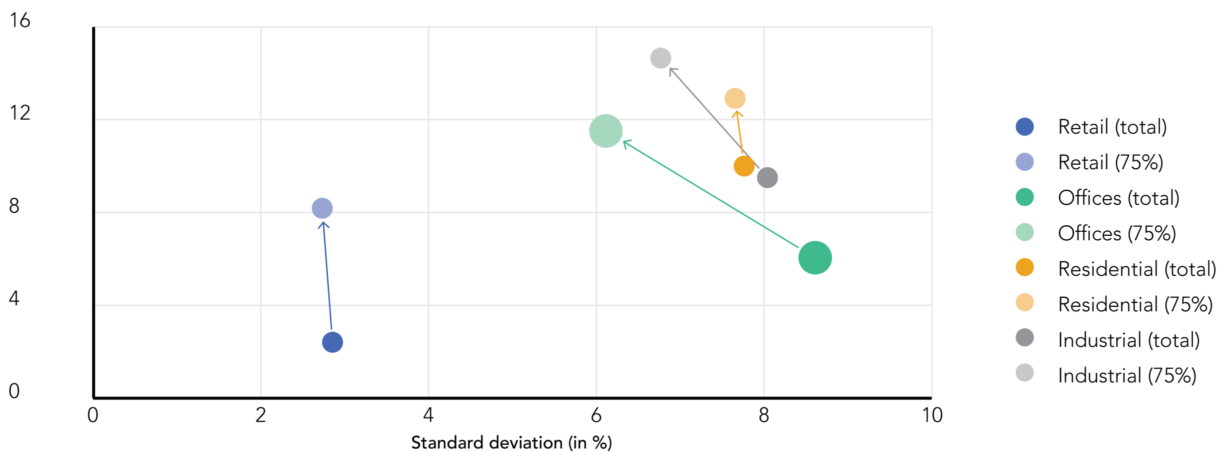
Differences in return and volatility can be observed when comparing the best 25% (MSCI's 75% percentile[1]) of each Dutch real estate sector with their respective total benchmark.

For offices, these differences are substantial. The historical total return of the 75% percentile is higher than the office benchmark, while the volatility is significantly lower (see Figure 1). The average annual historical total return outperformance was as high as 550 bps (2014-2023).

For the industrial and residential sectors, the best quartiles have lower total return outperformance, and the volatility difference is slightly lower. The best retail quartile shows similar return outperformance but almost no difference in volatility.

The average annual outperformance on the total return of the 75% office percentile grew to 660 bps between 2019 and 2023. The difference in volatility between this percentile and the total benchmark has continued to grow in recent years, underlining the growing polarisation in the office sector and the resilience of the 75% office percentile in turbulent macroeconomic circumstances. Careful asset selection is both essential and an opportunity, especially in the office sector.

Figure 1 Average Dutch total return and volatility 75% percentile vs. total benchmark (2014-2023)



Source: MSCI and a.s.r real estate, 2024

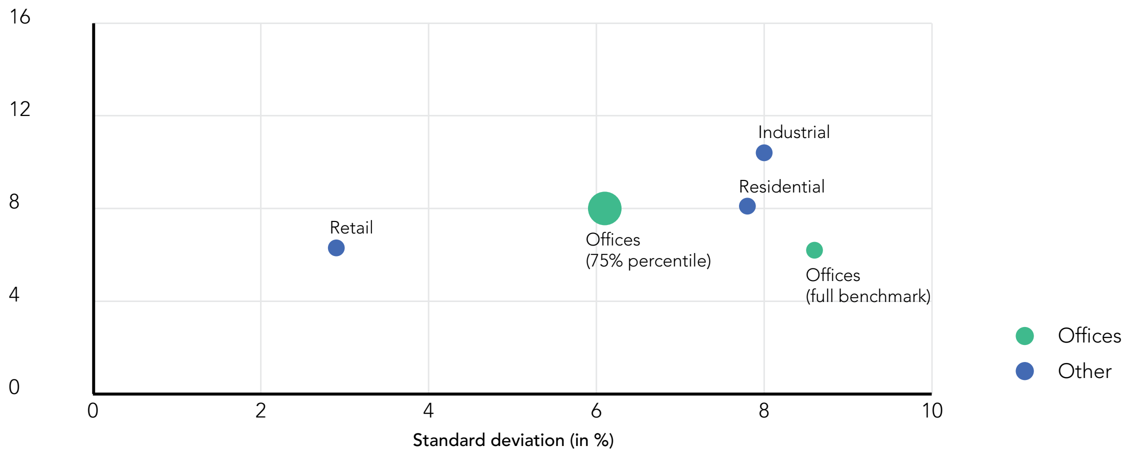
1 25% of Dutch MSCI office assets with highest historic total return (2014-2023)

Continuing polarisation in the office sector is prompting a strategic rethink

Integrating our views of the polarising Dutch office market into MPT triggers different strategic allocation outcomes. We started with a sector mix of Dutch residential, retail, offices and industrial, then we maximised sector allocations at 30% to enhance diversification.
When using the Dutch MSCI full office benchmark for MPT calculations, optimal office allocation would be limited to 10% in a Dutch real estate portfolio based on 2025-2028 expected returns. The expected return cannot compensate for the relatively high volatility. The industrial, residential and retail sectors have the better risk/return ratios. Therefore, all three have the maximum 30% allocation.

Figure 2 Risk vs. expected total return Dutch real estate sectors (2025-2028)

Expected total return 2025-2028 (in %)



Standard deviation (in %)

Source: MSCI and a.s.r. real estate, 2024

Taking advantage of new office allocation opportunities

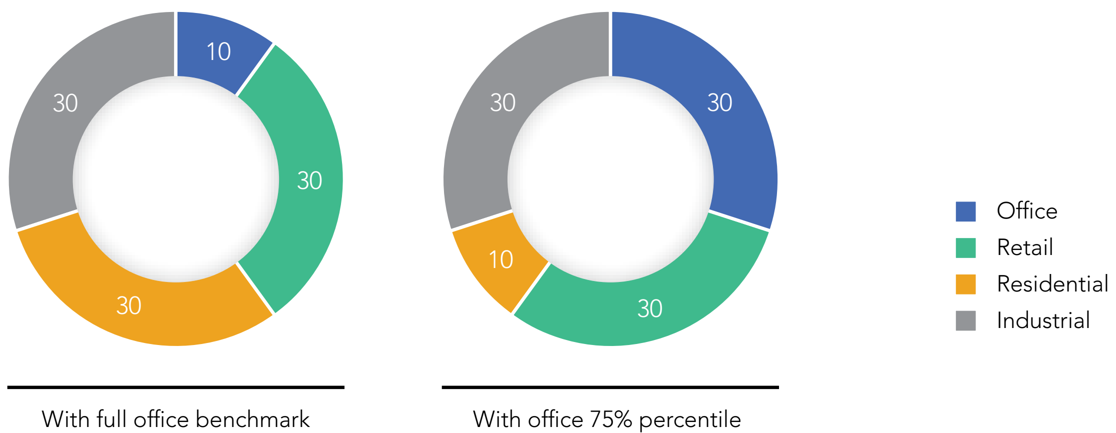
With the growing polarisation in the office market, we think it is prudent to assume at least 250 bps capital growth outperformance for 2025–2028 (see Figure 2). Outperformance between 1995-2021 was 350 bps, and both occupiers and investors are increasingly focusing on the top quartile, strengthening occupancy rates, market rental value growth, and potentially yield shifts. Therefore, the forecasted yields of the top quartile are lower than the total office benchmark as markets demand a lower risk premium for these assets.

Incorporating these assumptions into our calculations raises the theoretical office allocation to 30% (see Figure 3). High expected total returns and relatively low volatility result in a higher Sharpe ratio and increase the office sectors' investment attractiveness. This is at the cost of residential allocation, which has relatively high volatility.

This does not necessarily mean that investors should aim for a 30% office allocation. They should, however, be mindful of the potential benefits of adding more office exposure if the right opportunity arises. The growing polarisation in office demand is making this more critical over time. The investment characteristics of the office 75%-percentile are especially appealing for institutional investors looking for higher real estate returns with relatively low volatility.

Figure 3 Optimal theoretical Dutch real estate portfolio

Percentage



Source: MSCI and a.s.r. real estate, 2024

The follow-up articles provide insight into distinguishing winning office locations and assets from losing locations and assets. They will uncover the features that drive up rents, lower vacancy rates, support ESG goals and help in the competition for talent. They will also explain how buildings with strong ESG credentials and adaptable spaces are shaping the future of office assets, boosting engagement and productivity.

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