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A Case for Private Real Estate Within Investor Portfolios

By Steve Gruber and Scott Davies

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A Case for Private Real Estate Within Investor Portfolios

By Steve Gruber and Scott Davies

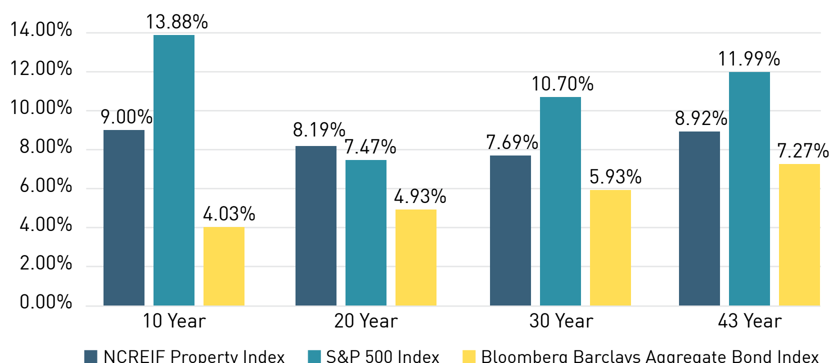
As institutional investors have optimized their portfolios along the risk and return continuum, real estate has become a meaningful portion of their asset mix, with the average institution allocating nearly 11 percent of its investments to the asset class.[1]

It is little wonder that real estate has become a portfolio mainstay. The asset class has exhibited low correlations to both stocks and bonds and demonstrated a long track record of achieving attractive risk-adjusted returns. Real estate historically has provided investors a steady source of income as well as an inflation hedge—important features in the current market environment.

Despite these benefits, high-net-worth investors have not accessed the asset class to the same degree as institutional investors. This article explores how carving out a private real estate allocation may be beneficial and provides an overview of the types of real estate investments and strategies available to investors so that they may create a private real estate allocation that is appropriate for their investment objectives, risk tolerance, and liquidity needs.

Figure 1

TRAILING RETURNS AS OF DECEMBER 31, 2020

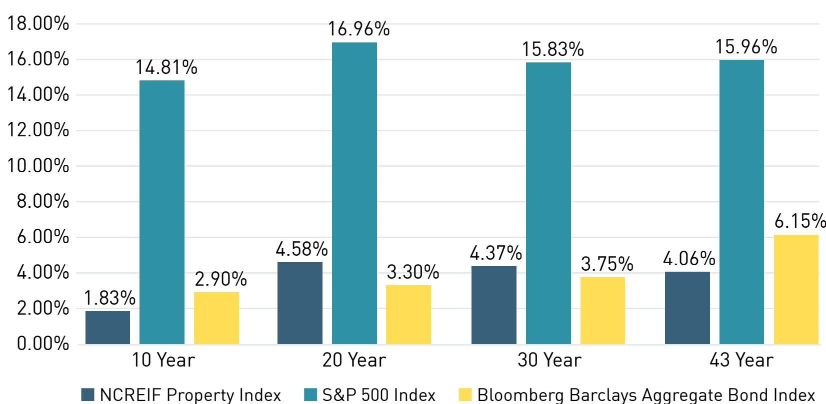


Source: Bloomberg

Past performance is not an indicator of future performance.

Figure 2

TRAILING STANDARD DEVIATIONS AS OF DECEMBER 31, 2020



Source: Bloomberg

Past performance is not an indicator of future performance.

WHY PRIVATE REAL ESTATE?

Four characteristics of private real estate warrant its consideration in a portfolio: the potential for attractive risk-adjusted returns, low correlation to traditional investments, income generation, and inflation protection.

The return characteristics stand out most. As figures 1 and 2 show, the NCREIF Property Index,[2] a standard benchmark for private real estate, outperformed the S&P 500 Index over the trailing 20-year period, and it outperformed the Bloomberg Barclays Aggregate Bond Index (Barclays Agg) in each of the trailing 10-, 20-, 30-, and 40-year periods. Most notably, real estate returns were generated with very low standard deviations, leading to more-attractive Sharpe ratios than either stocks or bonds.

ANNUALIZED RETURNS

Historically speaking, one of the reasons for stability in private real estate has been its sources of return, as shown in figure 3. Unlike equities, the bulk of total return for core real estate comes from income, not appreciation. This can

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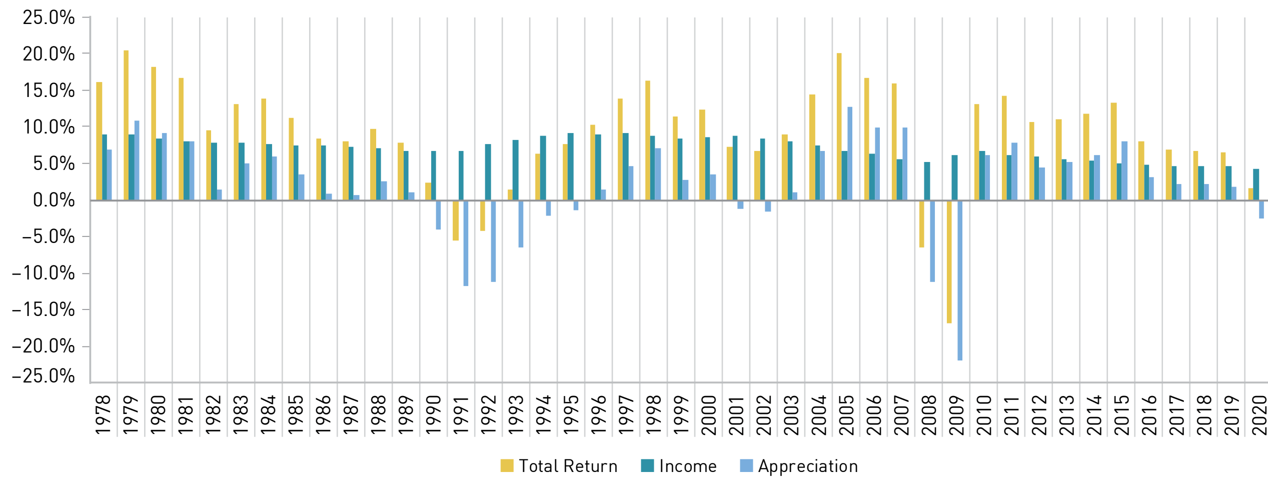
Figure 3

NCREIF PROPERTY INDEX AS OF DECEMBER 31, 2020



Source: https://www.ncreif.org/

Table 1

CORRELATIONS (MARCH 31, 1978–DECEMBER 31, 2020)

	Correlations		
	NCREIF Property Index	S&P 500 Index	Bloomberg Barclays Aggregate Bond Index
NCREIF Property Index	1.00		
S&P 500 Index	0.07	1.00	
Bloomberg Barclays Aggregate Bond Index	(0.12)	0.11	1.00

provide a steady return baseline, even if the property value declines or does not appreciate sharply.

Notably, the source of that income—rent collections—has held relatively steady. Even at the height of the coronavirus pandemic, rent collections across surveyed members of the National Association of Real Estate Investment Trusts (NAREIT) generally held strong despite many properties having low physical occupancy; occupancy fell to an average of 87 percent across property types in April 2020 but rebounded to an average of more than 93 percent by July 2020.

The income profile of private real estate has led to strong capital preservation. The NCREIF Index has experienced negative total returns in just four of the past 40 calendar years. Comparatively speaking, the S&P 500, arguably the core-equivalent of the equities market, has had negative returns in nine of the past 40 years. Equities have leverage embedded in their capital structures, but the NCREIF returns are presented on an unlevered basis; and companies in the S&P 500 need to demonstrate growth in order to generate returns, but real estate relies on embedded cash flows as its primary source of value.

Although returns have been attractive, investors still must consider how the investment fits within a broader portfolio. Historically, private real estate has provided valuable diversification benefits. As table 1 shows, over the past 42 years the NCREIF Property Index has demonstrated low correlation to the S&P 500 Index and negative correlation to the Barclays Agg Index.

INCOME GENERATION AND INFLATION PROTECTION

Historically, diversification and attractive risk-adjusted returns have been two hallmarks of private real estate investing that are relevant in any market environment. Some of the asset class's other features are particularly salient in today's market construct. With rates tethered near historical lows, it has become increasingly difficult for investors to find income-producing investments without taking on excessive risk. Private real estate has been a steady source of income, with the NCREIF Index providing a higher yield than (1) the Barclays Agg in 14 of the past 15 years; (2) the FTSE NAREIT Index, a public real estate benchmark, in 13 of the past 15 years; and (3) the S&P 500 dividend yield in each of the past 15 years.

Inflation protection is an additional feature. The nature of real estate leases provides most real estate operators, particularly those with the most desirable properties, the ability to raise rents periodically and pass through operating expenses. For the multifamily sector, leases are short-term, allowing the owner to reset leases at higher prices on a more frequent basis. Other property types such as offices have longer-term lease contracts, but these leases typically include price escalators, and, more often than not, are triple net leases where expenses such as taxes, insurance, and maintenance are passed through to the tenant. In both cases, the contracts generally give the operator the ability to increase revenues to offset a rising price environment.

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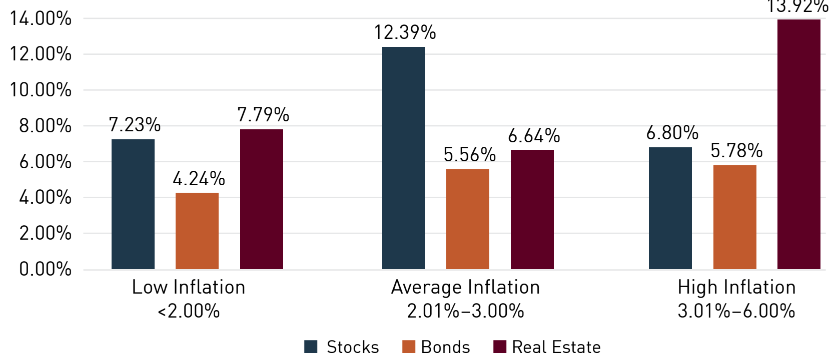
At the same time, higher building costs in inflationary environments increase the replacement cost of comparable real estate assets. This, in turn, can provide owners of existing properties the ability to increase rents, helping ensure that owners receive appropriate return on their capital.

Figure 4 demonstrates how the asset class has held up in previous inflationary periods (defined by inflation above 3 percent). With favorable supply and demand dynamics continuing to tilt pricing power in favor of landlords, we believe the asset class should again offer investors inflation protection in the current economic environment.

Figure 4

AVERAGE RETURN IN INFLATION ENVIRONMENTS (1999–2019)



Source: Hamilton Lane

PRIVATE REAL ESTATE CONSIDERATIONS

SECTORS, STRATEGIES, AND ALLOCATION LEVELS

As the private real estate market has matured in recent decades, so too have its investment options. Strategies can specialize in a specific type of real estate or invest across property types. Different strategies also target different levels of risk and different investment objectives, with some focusing on income, others targeting capital appreciation, and others seeking a mix.

For advisors and clients new to the asset class, it is critical that they understand the features of each property type and the risk and return parameters of different real estate strategies so that they assemble an allocation that is right for their own objectives. This section provides an overview of the asset class, including the main property types, the strategies within private real estate, and allocation considerations.

There are four main categories of commercial real estate:

Residential. The residential category includes any for-rent residential buildings from garden apartments to mid-rise and high-rise units. Properties also range in quality from class A luxury to class B/C workforce housing depending on age, amenities, location, deferred maintenance, lack of professional management, etc. Residential strategies also can include for-rent single family homes. Typically, residential has been one of the most resilient and durable real estate categories, due in large part to its necessity. Housing is a basic, essential need and with large year-over-year increases in the sales prices of single family housing, rental housing remains relatively affordable. Given its importance in an individual's personal financial budget, rent is typically the last item cut from budgets, resulting in the category being less sensitive to economic cycles.

Industrial. The industrial segment includes commercial real estate dedicated to manufacturing, warehousing, and logistics facilities. Unlike the residential segment, where lease terms generally are 12 months, industrial leases typically are three to five years or longer. The lease structure is on a net basis, allowing for the pass through of property taxes, insurance, and some maintenance. This lease structure historically has made industrial less economically sensitive to changes in gross domestic product relative to other property types. Notably, the segment has benefited in recent years from the rise of e-commerce, which has led to increasing demand for regional distribution warehouses and "last mile" logistics facilities.

Retail. A large and diverse sector, retail includes power centers (which include one or more big box retailers), regional malls, larger strip centers that are anchored by a grocery store or other large retailer, and also small strip centers with just a few stores. Retail properties tend to perform better during an uptick in the economic cycle. However, some properties that cater to basic necessities such as grocery-anchored strip centers have shown performance resiliency throughout the cycle. Likewise, location continues to be an important factor in the success of any retail location. Location is particularly important with the shift to e-commerce, which is more likely to impact secondary rather than primary locations.

Office. The office segment includes class A, B, and C office space. Class is determined by several factors including property age, location, systems, finishes, and design. Given the wide range of properties within the office segment—from class A trophy assets in urban core markets to class C office space outside a city or suburb—it is nearly impossible to make generalizations. Although the office category typically carries longer-term leases, usually 10 years, it is volatile relative to residential or industrial real estate because its activity and pricing can change with business activity. Further, capital expenses are typically higher in office buildings relative to other property types, leading to lower cash-on-cash returns on average.

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Development time frames often are longer as well, making it difficult for developers to balance supply and demand because market conditions can change while a property is under development.

Other property types. Residential, industrial, retail, and office are the four main categories of private real estate, but a number of other types don't fit within those buckets. These include senior living, medical office, student housing, self-storage, leisure (golf courses, entertainment venues, parks), hotel, and data-center properties.

Key takeaways

The relationships between property type, macroeconomic trends, and economic cycles are nuanced and complicated. As table 2 shows, mainly for non-core real estate, each category has experienced periods of superior performance. Further complicating the picture is the fact that the characteristics of sub-categories within each real estate category vary considerably. Given the differences, many investors maintain a diversified portfolio across real estate property types, investing in properties that are suitable for the risk and return goals defined by a specific real estate strategy.

WHAT'S CHANGING WITHIN SECTORS?

We believe real estate can provide meaningful diversification and total return benefits to institutional and personal portfolios. Investors shouldn't look to the asset class for liquidity but should think of real estate as a crucial portfolio component to be rebalanced over time as an investor's risk profile changes. In the near term, macro trends are creating favorable entry points to opportunities in the real estate sector:

Residential. The housing shortage in North America and other markets is real and construction prices continue to increase. This, coupled with a labor shortage, is expected to depress new build activity, allowing for all types of residential owners to increase rents in excess of inflation annually.

Industrial. We continue to see global demand for logistics space, particularly in last-mile distribution properties with parking for trailers and power for charging electric vehicles. This sector has been among the most resilient in the past 10 years, although these tend to be smaller assets, making it more difficult for investors to achieve scale.

Retail. The retail sector has been battered by the pandemic and by the movement to e-commerce. However, we believe grocery-anchored locations serving dense, higher income demographics within three to five miles will prove resilient over time. Negative sentiment due to the impacts from e-commerce that ignore higher and better use and redevelopment potential is increasing the relative risk-return profile of this property type.

Office. The pandemic and improvements in technology have made work from home (WFH) a viable option for many employees, particularly those in white-collar jobs. Uncertainty as to the impacts of WFH make this a more favorable time to invest in office because the property type is out of favor. Required improvements regarding indoor air quality, employee spacing, and other factors may force sales of properties that would otherwise be unavailable.

Table 2

PERFORMANCE BY PROPERTY TYPE

2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Apartments 18.21%	Apartments 15.45%	Retail 11.60%	Retail 12.86%	Industrial 13.42%	Retail 15.28%	Industrial 12.31%	Industrial 13.07%	Industrial 14.30%	Industrial 13.36%	Industrial 11.78%
NPI 13.11%	Industrial 14.59%	Apartments 11.24%	Industrial 12.32%	Retail 13.12%	Industrial 14.87%	Retail 9.04%	NPI 6.96%	Hotels 7.57%	Office 6.59%	Apartments 1.83%
Retail 12.62%	NPI 14.26%	Industrial 10.71%	NPI 10.99%	NPI 11.82%	NPI 13.33%	NPI 7.97%	Apartments 6.16%	Office 6.85%	NPI 6.42%	NPI 1.60%
Office 11.74%	Retail 13.76%	NPI 10.54%	Apartments 10.41%	Office 11.50%	Hotels 13.20%	Apartments 7.33%	Office 6.03%	NPI 6.72%	Apartments 5.51%	Office 1.57%
Industrial 9.37%	Office 13.76%	Office 9.49%	Office 9.86%	Hotels 11.06%	Office 12.50%	Office 6.20%	Retail 5.67%	Apartments 6.07%	Hotels 3.51%	Retail -7.48%
Hotels 8.97%	Hotels 11.80%	Hotels 8.25%	Hotels 7.69%	Apartments 10.29%	Apartments 11.99%	Hotels 4.71%	Hotels 4.93%	Retail 2.18%	Retail 1.90%	Hotels -25.56%

Source: NCREIF as of December 31, 2020; NPI = NCREIF Property Index

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IDENTIFYING AN APPROPRIATE INVESTMENT STRATEGY

When allocating to private real estate, it is important to match a strategy with the investor's specific investment objectives. Strategies fall into four categories, each with a different risk and return profile:

Core. Core real estate generally is defined by high-quality properties in major markets with low vacancy rates. Properties tend to be large and expensive (single office buildings in major markets worldwide regularly trade for more than US$1 billion), and investors purchase them for the stable income stream the asset generates. Assets usually are purchased with relatively low leverage, which means that if the asset value fluctuates, the effect on the investor's equity is not as severe. The bulk of returns in a core strategy will come from current income with modest appreciation. In general, annual return targets for core real estate are in the mid-single digits.

Core-plus. A core-plus strategy often comprises real estate assets with lower occupancy rates and slightly higher leverage than a core property. Often, a core-plus investment strategy can require some minor improvement to the property—a new lobby, new systems within a building, cosmetic upgrades, or other marginal enhancements—to drive higher occupancy and leasing. A core-plus strategy typically employs marginally more leverage than a core strategy, and total return comes from a combination of current income and appreciation. Generally, core-plus annual returns often are in the high-single digits.

Value-add. Properties for this type of strategy usually require larger renovations, often reconfiguring space or repositioning the asset. Such properties use more leverage and have higher leasing risk, but they also offer potential for greater appreciation after the property is improved, re-leased, and fully occupied. Although riskier than core or core-plus, value-add target returns generally are in the low teens.

Opportunistic. Properties within the opportunistic bucket usually are built from the ground up or involve a major renovation of an existing structure. Properties are held for a shorter period and nearly all the investment return comes from appreciation; investors should expect little to no current income with an opportunistic strategy. Although the opportunistic strategy is furthest out on the risk spectrum, it offers the highest return potential with target returns in the mid- to high teens.

Key takeaways

Some investors classify risk across a portfolio as core, core-plus, value-add, and opportunistic; others think of risk simply in terms of core and non-core. Regardless of nomenclature, the further the investor moves from core real estate, the more the investment return comes from appreciation as opposed to income. As investors move from core to opportunistic, they also are taking on more risk but could achieve potentially higher returns.

As a rule of thumb, investors should allocate only the amount they are comfortable having locked up for a longer period of time;

ALLOCATION DECISIONS

Decisions about how much to allocate to private real estate generally depend on the investor's time horizon and tolerance for illiquidity. Assuming the rest of the portfolio is in liquid investments, common allocations to private real estate range between 3 percent and 15 percent of the total portfolio. As a rule of thumb, investors should allocate only the amount they are comfortable having locked up for a longer period of time; core open-end funds usually provide for periodic liquidity, but this is usually on a best-efforts basis, and closed-end funds pursuing a non-core strategy can have fund terms of 10 years or more. Investors should expect it to take time for net income and value to grow for most real estate investments, and they should therefore take a longer view. Implementation of a business plan for a recent acquisition often takes time to execute as in-place leases are recalibrated, exterior and interior renovations are completed, and other value enhancement objectives are met.

Along with how much to allocate, advisors and their clients also must decide how far on the risk spectrum they wish to venture and the weightings across property types or geography. This is largely a function of whether the goal is income, appreciation, or both. Income-oriented investors would focus mainly on adding core real estate strategies, and appreciation-oriented investors would look to more value-add and opportunistic strategies. Some investors also utilize multiple strategy types to assemble real estate allocations that target both an expected return and yield profile. For example, an investor may consider (1) a risk allocation of 50 percent core, 30 percent value-add, and 20 percent opportunistic, (2) a property type allocation that overweights income generation (bias to multifamily and industrial) or equal weighting across the major property types, and (3) a geographic allocation that may over- or underweight coastal markets, or that is biased to higher-job-growth regions. Risk exposure and actual performance can vary considerably based upon portfolio construction. This is why working with a knowledgeable advisor can be beneficial.

CONCLUSION

Although private real estate has a long history of providing attractive, risk-adjusted returns, we believe the current market environment makes it particularly relevant to consider the asset class. With the average equity valuations over the past two years sitting nearly 42 percent higher as of January 1, 2022, compared to their 40-year average,[3] and questions around interest rates and

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persistently low bond returns, investors are pressed to find sources of return that are uncorrelated to either. Private real estate could be one such option. The asset class also can address two timely needs: income generation and inflation protection.

Although these features can make private real estate an attractive addition to a broader portfolio, investors must approach the asset class with clear objectives. The optimal strategy is largely a function of whether the investor is seeking income, total return, or both. Investors also must understand the differences among property types and how the underlying strategies they use are allocating to each, so that they have a reasonable expectation of how strategies might behave during an economic cycle. With a clearer understanding of both private real estate strategies and property types, advisors can choose from a wide array of private real estate options to assemble a portfolio that is right for their client's goals.

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ENDNOTES

1. See "Institutional Investors Increased Allocation to Real Estate This Year, Remain Under-Allocated," Commercial Real Estate Direct (December 15, 2020), https://crenews.com/2020/12/15/institutional-investors-increased-allocation-to-real-estate-this-year-remain-under-allocated/.
2. A comprehensive definition can be found at https://www.ncreif.org/data-products/property/.
3. See Current S&P 500 PE Ratio, www.multpl.com.

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