A case for private real estate in HNW investor portfolios

Scott Davies

As institutional investors have optimised 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% 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 (HNW) investors have not accessed the asset class to the same degree as institutional investors.

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 National Council of Real Estate Investment Fiduciaries (NCREIF) Property Index (NCREIF 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.

Historically speaking, one of the reasons for stability in private real estate has been its sources of return. Unlike equities, the bulk of total returns for core real estate comes from income, not appreciation. This can 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% across property types in April 2020, but rebounded to an average of more than 93% by July 2020.

The income profile of private real estate has also 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 Index has demonstrated low correlation to the S&P 500 and negative correlation to the Barclays Agg.

Table 1. Correlations (31 March 1978–31 December 2020)

	Correlations		
	NCREIF Index	S&P 500	Barclays Agg
NCREIF Index	1.00		
S&P 500	0.07	1.00	
Barclays Agg	(0.12)	0.11	1.00

Income generation and inflation protection

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 the Barclays Agg in 14 of the past 15 years; the FTSE NAREIT Index, a public real estate benchmark, in 13 of the past 15 years; and 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.

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

Private real estate considerations

For advisers 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.

The relationships between property type, macroeconomic trends, and economic cycles are nuanced and complicated. Each category has experienced periods of superior performance. Further complicating the picture is the fact that the characteristics of subcategories within each real estate category vary considerably.

The quote

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.

Scott Davies, Hamilton Lane

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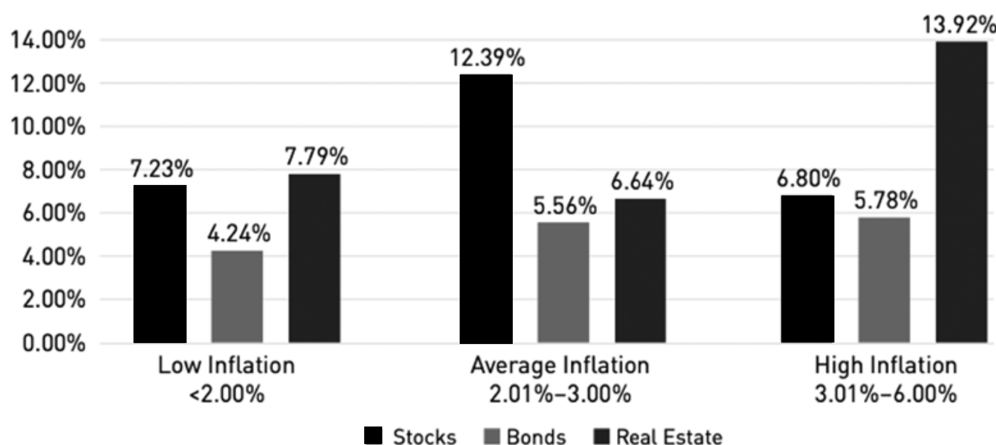
Figure 1. Average return in inflation environments (1999–2019)



Left-hand column = stocks Middle column = bonds Right-hand column = real estate

Source: Hamilton Lane

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.

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, released, 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.

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%–15% of the total portfolio.

Along with how much to allocate, advisers 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 use multiple strategy types to assemble real estate allocations that target both an expected return and yield profile. For example, an investor may consider:

- a risk allocation of 50% core, 30% value-add, and 20% opportunistic
- a property type allocation that overweights income generation (bias to multifamily and industrial)
- equal weighting across the major property types
- a geographic allocation that may over- or underweight coastal markets, or that is biased to higher-job-growth regions.

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% higher as of 1 January 2022, compared to their 40-year average,[3] and questions around interest rates and 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, advisers can choose from a wide array of private real estate options to assemble a portfolio that is right for their clients' goals. **FS**

Notes

1. 'Institutional investors increased Allocation to Real Estate This Year, Remain Under-Allocated', *Commercial Real Estate Direct, 15 December 2020.*
2. A comprehensive definition can be found at https://www.ncreif.org/data-products/property/.
3. See current S&P 500 PE ratio at https://www.multpl.com/s-p-500-pe-ratio.