AMERICAN
REALTY ADVISORS
INSTITUTIONAL CAPITAL MANAGEMENT

Revisiting the Case for Core Real Estate in 2021

Enhancing stability in an unstable environment.

EXECUTIVE SUMMARY

U.S. core real estate has long been an "all-seasons" investment strategy, providing a stabilizing income-oriented return element in investors' multi-asset portfolios throughout market cycles.

Core properties held in open-end funds are most akin to traditional fixed-income instruments, though have historically offered income returns in excess of bonds.

With low-yielding bonds an ongoing hallmark of U.S. monetary policy, private core real estate has become a critically vital source of reliable income for investors to meet their distribution requirements.

"...the short-term funding pause into core offerings prompted by pandemic uncertainty may provide an attractive entry point for proactive investors to increase their exposure..."

Current and anticipated operating challenges in discretionary retail and office may inherently make some core funds' holdings less "core like" going forward but also drive further appreciation in other sectors.

Not all core funds reflect the ODCE; diligent fund selection offers the potential to "beat the benchmark".

Investors remain under-allocated to real estate relative to stated targets; the short-term funding pause into core offerings prompted by pandemic uncertainty may provide an attractive entry point for proactive investors to increase their exposure to core real estate.

While investors were watching the ensuing volatility from the pandemic wreak havoc on equity and REIT markets in 2020, private core real estate continued along, registering a relatively benign one-quarter blip before returning to its steady positive total return trajectory. Yet very little attention has thus far been paid to this resiliency as a reason for re-evaluating the case for core.

Yet with bond yields lacking, finding alternative sources of resilient income is becoming an increasingly critical task for investors in order to satisfy distribution needs today. With the historical reasons for holding core real estate in a mixed-asset portfolio still as relevant as ever, investors who may be considering swapping some of their fixed-income bucket into higher-yielding alternatives or simply contemplating a shift in core managers may find that now is an opportune time to revisit the case for private core real estate.

What has made core real estate appealing historically?

Given the maturity of commercial real estate as an asset class, the rationale for investing in core real estate is well-cited. Yet to engage in a discussion about why now might be an opportune time to revisit an allocation to core, it is important to recap why it has earned a role in institutional portfolios. Although no doubt a simplified list, the following represents the most common rationale for having historically invested in private core real estate.

Low correlation to other asset classes:

Core private real estate has, both over the long term and during the latest cycle, demonstrated a low correlation to REITs, equities, and bonds, serving as a diversifying and thus de-risking agent in mixed asset portfolios;

Reliable income streams:

With roughly 80% of core real estate's total returns derived from income, the asset class has offered investors a reliable routine source of income;

Attractive yields:

Private real estate yields have historically offered a higher relative yield spread to government bonds than REITs or equities; and

Partial hedge against inflation:

Because real estate values tend to rise during periods of higher inflation (due to rising replacement costs and strong macroeconomic fundamentals fueling demand), private real estate can serve to partially offset any adverse impacts of inflation in other parts of investors' portfolios.

80%

of core real estate's total returns derived from income

What makes core real estate compelling today?

While there are those who have put a pause on increasing their allocation to core real estate in recent quarters amidst concerns over it being overpriced and thus not offering sufficient portfolio value, we are here to suggest that core remains a compelling alternative to other capital buckets. The logical question to ask is "Why today?"

To answer this question, we should consider the convergence of three macro forces that, in our view (and candidly, the view of many others) are likely to drive core real estate performance in 2021 and in the years ahead:

1. Low risk-free rates,
2. Rising institutional allocations to real estate (and a widening gap between allocations and commitments),
3. A shrinking supply of what counts as core.

The historical reasons for holding core real estate are still as relevant as ever. The logical question is "what makes core real estate compelling today?"

Relative yield spread to low government bonds.

Virtually all asset classes are more fully priced today relative to historic norms than at any point in modern history. When investors are making determinations about their allocation strategy, relative value becomes a more meaningful input. In this sense, private real estate yields today offer the highest spread relative to long-term government bonds when compared to the spread provided by REITs, equities, and Baa-rated corporate bonds, making them a compelling yield-bearing add-in for mixed asset portfolios (Figure 1).

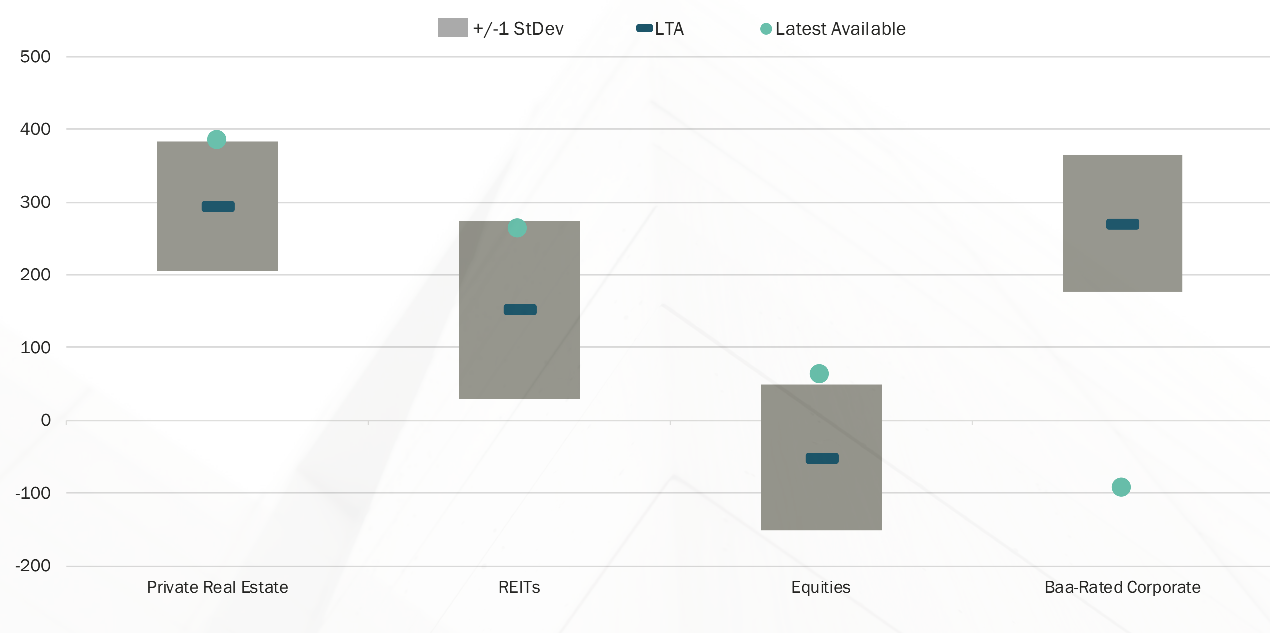
Real estate yields today offer a nearly 400-bp premium to long-term government bonds, higher than REITs, equities and Baa-rated corporate bonds.

And while expectations are for interest rates to remain low for the foreseeable future, private real estate's yield spread would be on par with the long-term average even if 10-year Treasuries increased by as much as 70 bps (still offering a nearly 300-bps yield premium).

This of course assumes that private real estate cap rates remain at their current levels and do not increase in tandem with rising bond rates to maintain the proportionate relationship between the two, a retort that has in recent years been used to explain a pullback from core as some investors have tried to call the top of the market. This is where a discussion about capital allocations (greater numerator) and supply (smaller denominator) comes into play.

FIGURE 1: Real Estate Yield Spread to Government Bonds[1]

Yield/Cap Rate Spread to Long-Term Government Bonds, Public and Private Real Estate, BAA-Corporate & Equities (bps)



Mismatch between capital appetite and allocations.

The appetite for real estate from institutional investors globally has been on the rise for the last seven consecutive years, with target allocations increasing by 10 bps year over year between 2019 and 2020, despite real or perceived impacts from the pandemic (Figure 2). While on a year-over-year basis this may seem a relatively benign increase, the 10-bp increase "implies the potential for an additional $80-$120 billion of capital over the coming years" with the anticipated 2021 targets reflecting a further and even more meaningful increase of 30 bps, putting institutional investors' target allocations to real estate closer to 11%.

Yet there has been a persistent shortfall between investors' targets and their committed allocations. As of June 2020 (when equity markets had not yet fully recovered from their March contractions, resulting in smaller AUM denominators), 62% of institutional groups noted they remained under-allocated to real estate relative to their stated targets.

With equities today now having handily surpassed their pre-pandemic highs, the denominator has recovered, putting groups even further below target.

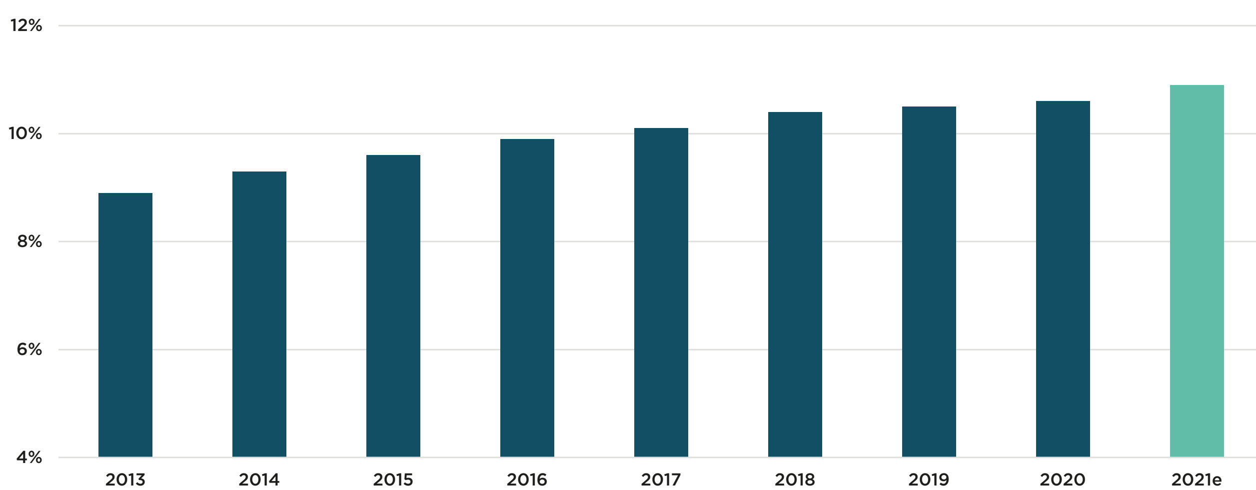
"…there is sufficient dry powder pursuing deals to support property values through the ongoing near-term uncertainty and keep current yields intact…"

This in and of itself suggests to us that, even if a quarter of the total to-be-allocated capital is seeking investment in core vehicles, there is sufficient dry powder pursuing deals to support property values through the ongoing near-term uncertainty and keep current yields intact, at least for the most resilient and sought-after property types. What's more, there may be further potential for greater appreciation on the other side.

And therein lies the third component of what we envision will drive further appreciation in the core space in the years to come.

FIGURES 2: Increasing Appetite for Real Estate From Institutional Capital[2]

Institutional Investors' Target Allocations to Real Estate, 2013 – 2021e (e=estimate)



A shrinking amount of core real estate.

One must consider what constitutes core to appreciate why there may indeed be less of it going forward. In short, core properties are characterized as stabilized, cash-flowing assets with minimal repositioning required. Yet there is increasing reason to believe that the disruptions occurring in the retail and office sectors have added operational challenges and strained cash flows to a point where a large chunk of these assets are no longer core. And because office and retail comprise roughly 48% of ODCE fund holdings, there is likely to be meaningful jockeying into the more resilient industrial and multifamily sectors (as well as some other, more specialized property types), creating greater competition for fewer assets.

We believe there is a forthcoming bifurcation in core funds' construction (and ultimately, performance) going forward. On the one hand, we can envision certain less-diversified funds going the way of single-sector-focused vehicles, offering core-like returns but with minimal diversification (thereby disqualifying from the ODCE universe, whose requirements state no more than 65% of market value can be concentrated in one property type or region). This strategy offers some positives, as it allows investors to increase their allocations to those specific sectors they have greater conviction in while minimizing exposure to those they do not, though it is accompanied with lessened diversification and/or the need to engage a greater number of managers to achieve diversification across property types, potentially negating some of the positives.

For those funds that remain committed to providing a diversified core offering, a greater adoption of synergistic sub-types (cold storage and data centers as a share of a larger industrial allocation, life sciences as a larger share of an overall smaller office element, single-family and suburban apartments as a diversified part of a residential component) will likely win the day in the medium- to longer term.

"We believe there is a forthcoming bifurcation in core funds' construction (and ultimately, performance) going forward."

It behooves core investors to carefully scrutinize the underlying holdings of those funds being considered to determine whether there exists a plan to reposition to take advantage of those secular and demographic tailwinds driving some sectors' outperformance, or whether the assets are inherently weak and may undergo significant value write-downs that are not likely to be easily mediated.

Now is the time to consider what's in your current core fund holdings — and whether those holdings are well positioned for future tailwinds.

Given this combination of healthy pent-up capital appetite and shrinking pool of true core assets, now may be an appropriate time to move opposite that of the herd in considering a re-up to core. While core real estate isn't the usual mechanism through which investors have sought to be contrarian, the shifting capital backdrop suggests increasing an allocation to core today may prove such a move. In anticipation of a wave of distressed deals in the aftermath of the pandemic, managers launched a multitude of opportunistic and distressed funds in 2020 in an effort to build up their war chests to jump on the buying opportunity and to capitalize on investors' appetite for more risk (Figure 3).

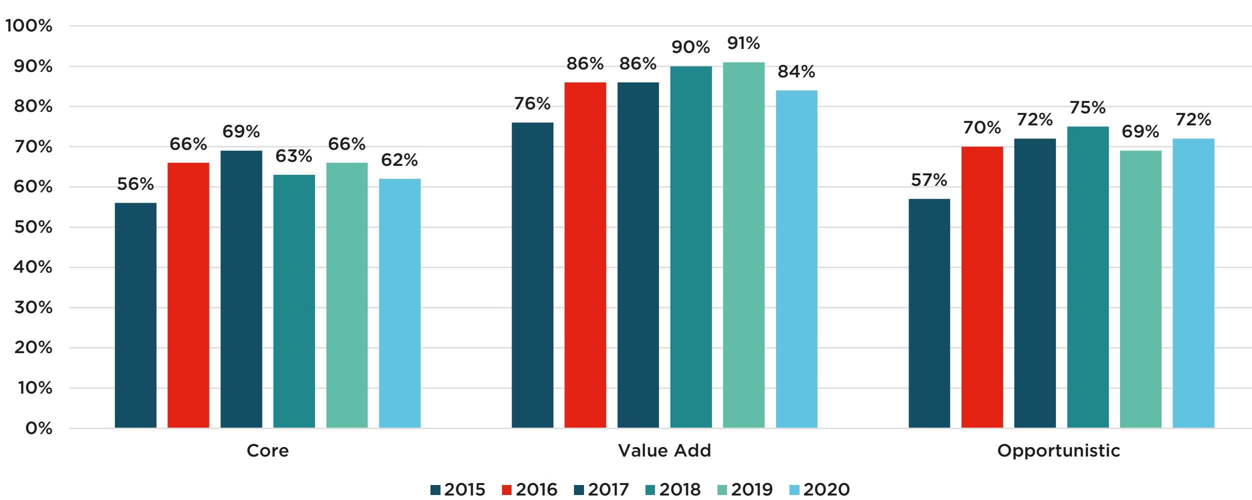
Yet with virus-induced impacts on commercial real estate having thus far been largely manageable, these funds may find the wave more appropriately sized for a boogie board than a surfboard, at least in the near term (as of Q3 2020, distressed asset sales represented just 1% of total transaction activity over the prior two quarters, with most occurring in retail and hotel).

While we believe distress may indeed emerge over the course of the next several years as longer-term leases in less-resilient properties role, the pace at which these deals come to market may result in these opportunities being bid up amidst increased competition to deploy, eroding their potential returns and inadvertently moving investors' committed capital further out on the risk-return spectrum.

While there is a role for higher-returning real estate strategies in investors' portfolios, an approach that is anchored by an allocation to core real estate that then tactically leans into and out of riskier vehicles when cycles dictate should provide both the alpha and beta institutional investors seek in their real estate holdings. Increasing one's core allocations at a time when more capital is focused on the other end of the risk-return spectrum can eliminate delays from otherwise-full entry queues and thus provide more immediate beneficial exposure.

FIGURE 3: Changes in Institutional Risk Preferences[3]

Real Estate Risk Preferences of Global Institutional Investors in Real Estate, 2015 - 20



Selecting a core fund

As we alluded to previously, we do not believe that all ODCE funds are likely to emerge from the current period having appropriately aligned themselves with the drivers of the next cycle, creating meaningful variability in potential core outcomes. This in and of itself is not a new consideration for core investors — recent history is marked by growing redemption queues from certain funds who failed to adapt to pre-pandemic forces — but bears repeating in a conversation about increasing or reallocating core commitments.

Unlike an equity or REIT index, there is no mechanism whereby private core real estate investors can invest directly into the ODCE benchmark. This means that, over any given timeframe, fund selection will either create out- or underperformance. But how should investors think about choosing a core fund?

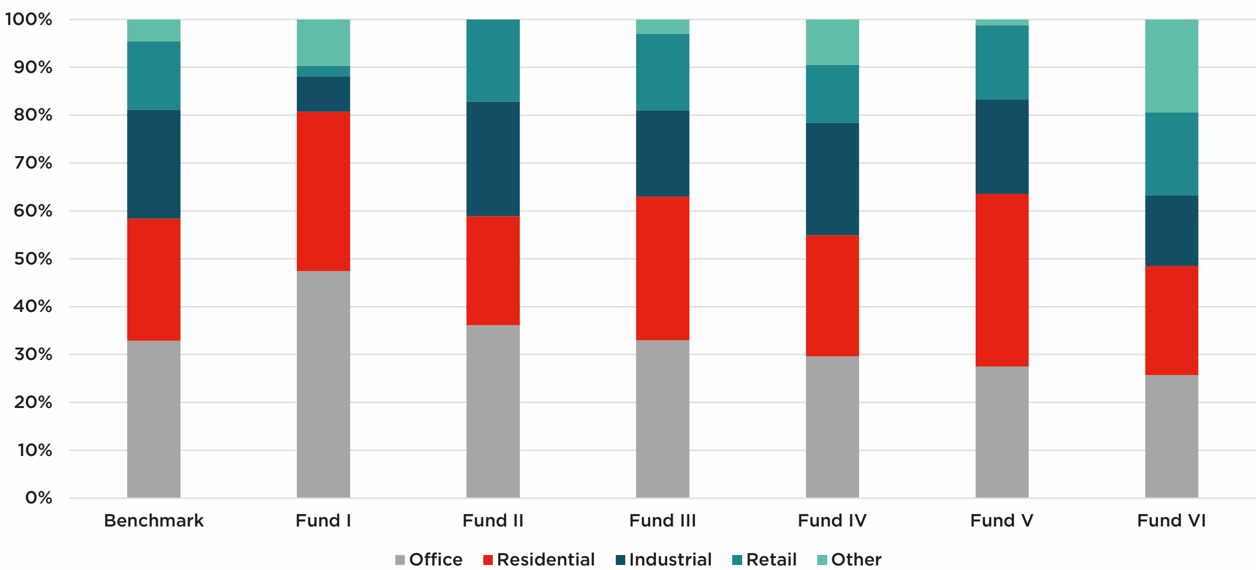
One filter to apply is sector allocation. As the core universe resizes, too much (or too little) exposure to contracting or growing sectors will become an even more meaningful driver of returns. It stands to reason then that investors should focus on those core funds whose sector strategy is oriented towards secularly supported property types. In Figure 4, we look at the NCREIF ODCE Value-Weighted Index by sector compared to six anonymized ODCE member funds as of the third quarter of 2020. What you can see is a materially different approach to sector exposure – Fund I has a nearly 50% allocation to office, though virtually no exposure to retail, whereas Fund VI has the least office exposure but the highest "alternatives" bucket. Without disclosing any more information, you can envision the materially different return profiles these six sample funds have had and will have going forward relative to what investors expect when they wish to gain exposure to ODCE returns.

This in isolation is fairly straightforward to apply in setting core fund selection criteria — however, one must also consider the relative size of the fund. Why might this matter? Too large, and a fund may not have the agility to pivot its holdings exposure in any real way; too small, and diversification can easily get out of whack upon the sale or acquisition of a single property (not to mention lessened buying power overall). Vintage should also be considered when evaluating recent rankings. Funds' entry timing into ODCE can produce "false positives" in terms of their outperformance staying power (i.e., they enter at an opportune moment when prospects for near-term outperformance are highest, thereby entering in the pole position). A fund that has continually risen in the rankings or maintains benchmark outperformance over a full real estate cycle is likely a more compelling candidate, as these characteristics signify an ability to adapt to changing preferences and offer more resilient staying power.

"Not all core funds are created equal — sector allocation, size, and vintage influence funds' outperformance "staying power".

FIGURE 4: Composition of ODCE Funds[4]

Composition of Select Anonymized ODCE Funds Relative to Benchmark as of Q3 2020



Conclusion

With institutions in a seemingly perpetual search for yield, core real estate can provide the necessary income required to cashflow match liabilities consistently, with annualized core fund income returning roughly 4% even throughout the volatility of 2020.

Yet a shifting profile of core properties suggests that not everyone's current core exposure may truly serve as "core" going forward — a reality that may trigger redistribution of existing core allocations to different core managers whose profiles are better suited for tomorrow's real estate market.

Furthermore, with the long-term drivers for including core real estate in mixed-asset portfolios still intact, the current funding shift towards riskier strategies may provide a compelling window for longer-term-oriented investors to play the contrarian and re-up their allocations to core before another wave of risk-aversion kicks in, allowing those investors who are willing to revisit the case for core in 2021 to benefit immediately from current in-place income streams and in the future from additional appreciation.

Now is a tactically opportune time to revisit the case for core real estate, a decision that will serve investors' portfolios well today and well into the future.

Endnotes

[1]Note: Sectors sorted from left to right by current spread to long-term government bonds (largest to smallest). Private real estate yields represented by the NPI equal-weighted current value cap rate, REITs are represented by the dividend yield from the FTSE Nareit All-Equity REITs Index, and equities represent the dividend yield from the S&P 500. Data reflects quarterly values. Data is through Q4 2020 with the exception of private real estate, which is based on third-quarter data (latest available). Source: American Realty Advisors based on data from NCREIF and Macrobond as of January 2021. LTA = Long-term average, 2007-2020. [2]Source: American Realty Advisors based on data from Hodes Weill & Associates' 2020 Institutional Real Estate Allocations Monitor and Investor Sentiment Webinar as of January 2021. [3]Ibid. [4]Source: American Realty Advisors based on data from NCREIF as of January 2021.

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