ARA RESEARCH

The Case for Core Real Estate in the Post-Pandemic Cycle

AMERICAN REALTY ADVISORS
INSTITUTIONAL CAPITAL MANAGEMENT

THE CASE FOR CORE REAL ESTATE IN THE POST-PANDEMIC CYCLE

EXECUTIVE SUMMARY

- Private core real estate is a key building block of investors' real estate exposure, which can offer stable income and lower volatility of total returns.
- Core profiles are evolving – specialty subsectors are growing increasingly important in fund construction.
- In times of market volatility, the long-term case for real estate should remain solid – income, inflation hedging, and diversification.

What is Core Real Estate?

Core real estate funds invest primarily in assets in major markets that have stabilized occupancy and minimal capital expenditures, and that seek to achieve strong and stable returns with the majority derived over the long term from income.

These portfolios form the foundation of an investor's exposure to the institutional real estate asset class. Investors utilize core as the basis upon which more tactical enhanced return strategies can then be layered to achieve return targets.

FIGURE 1

Characteristics of Different Real Estate Strategies

	Core	Core Plus	Value Add	Opportunistic
Return Ranges	7-10%, little variability	8-12%, modest variability	13-15%, some variability	20%+, high variability
Return Split	70%+ from income Remainder from appreciation	60-70% from income 30-40% from appreciation	50-70% from income 30-50% from appreciation	0-50% from income 50-100% from appreciation
Leverage	Limited; 10-30% LTV	Moderate; 30-50% LTV	Moderate; 40-60% LTV	High; 50-90% LTV
Market Profile	Primary/Liquid Secondary	Primary/Liquid Secondary	Primary/ Secondary	Secondary/ Tertiary
Asset Profile/ Strategy	Stabilized Little/no deferred maintenance 85%+ occupied Hold and operate	Some lease up/ rollover Limited deferred maintenance 70%+ occupied Light improvements	Higher lease up/ rollover Some development/ build-to-core >70% occupied Major renovation/ repositioning	Ground-up development Complete redevelopment Little/No occupancy Significant rehabilitation
Risk Profile	Lowest	Low	Moderate	Highest

Source: American Realty Advisors

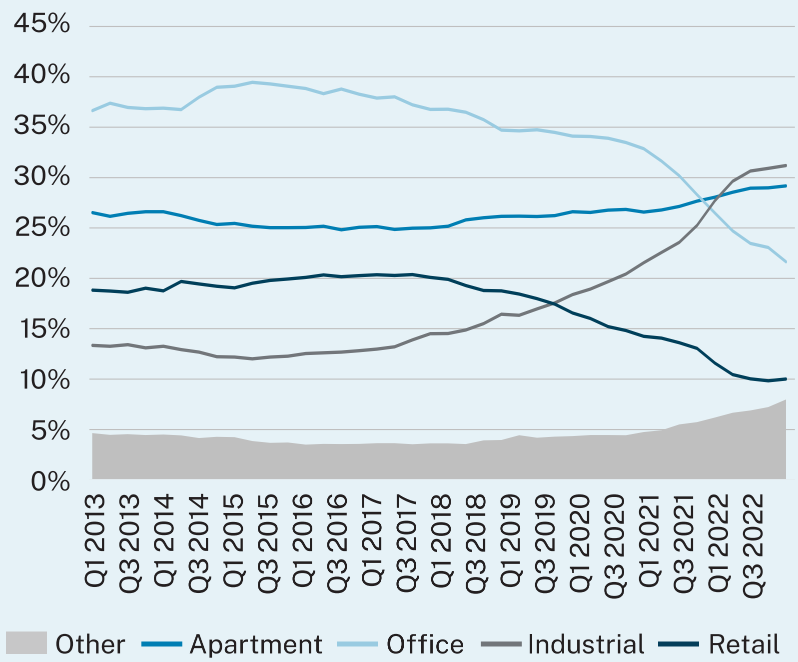
How Are Today's Core Portfolios Evolving?

Although the goals that investors seek from core real estate portfolios have remained largely constant throughout market cycles, what constitutes core in terms of property types has not. Not only have allocation preferences shifted but more recently, the opportunities to delve deeper into variations on the basic "four food groups" — industrial, multi-family, office, and retail — have given investors a wider opportunity set from which to build their allocations.

Traditionally, office had long represented the largest holding of ODCE core funds, accounting for more than a third of overall portfolios, with changes in utilization driven by work-from-home coming out of the pandemic, occupancy and values have been challenged and exposures are now below 22%. A similar dramatic shift in investments can be seen in industrial, whose share increased from 13.5% in 2013 to 31% by year-end 2022 (Figure 2).

FIGURE 2

Core Fund Allocations by Sector, 1Q 2013 – 4Q 2022



Source: American Realty Advisors based on data from NCREIF Fund Index – Open End Diversified Core Equity (NFI-ODCE). Data reflects value-weighted gross real estate values. Totals may not add up to 100% due to rounding.

Further, today's core portfolios are replete with creative ideas that dive deeper into each sector and provide "variations on the themes" of the four broad categories. Industrial now includes not only traditional inventory storage but also logistics centers, cold storage, and vertical models. What was previously just apartments has morphed into residential encompassing both multi-family and purpose-built single-family rentals communities. Other specialty themes including life science facilities, self-storage, and data center power shells are increasingly included in mainstream core portfolio strategies.

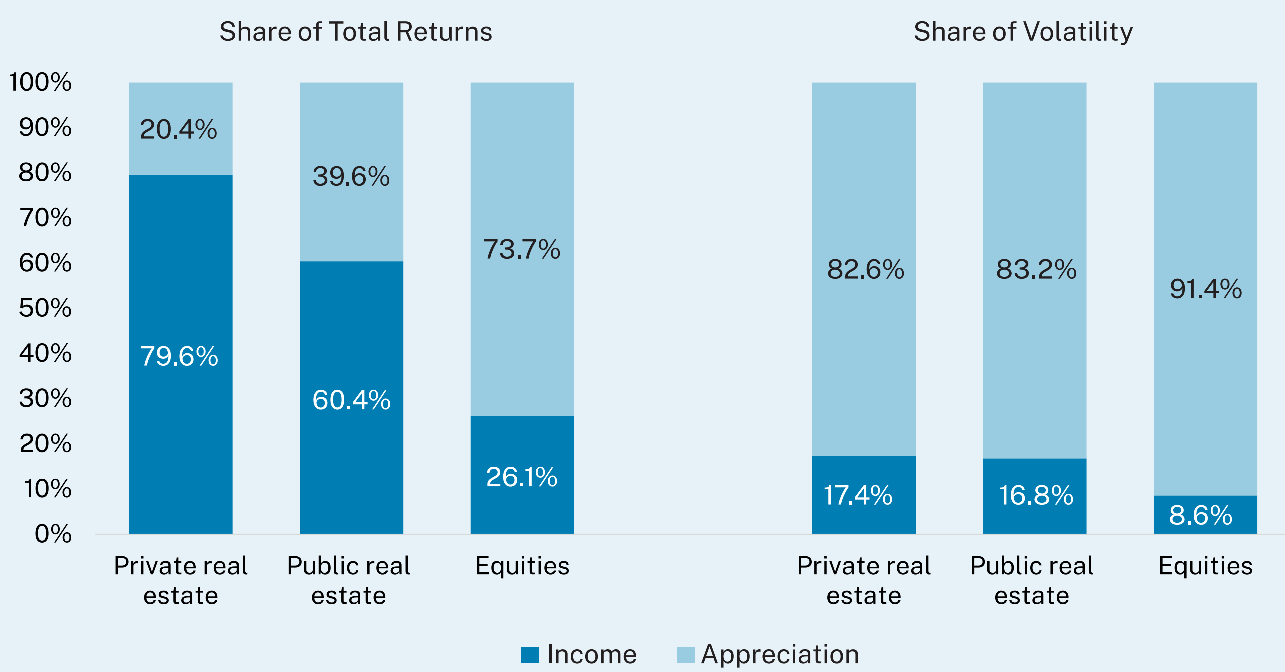
What Makes Core Real Estate a Long-term Portfolio Necessity?

Reliable Income Streams

In the last decade of historically low rates, real estate picked up the income role in most portfolios traditionally held by fixed income. Rental income provided a steady stream of cash flow for property operations and distribution to investors in need of cash flow. Even as rates have increased, the ability of real estate assets to increase rents in an inflation environment (as well as the benefit of appreciation) give real estate a continuing advantage over other fixed income sources such as bond and provides additional diversification to lower overall portfolio volatility. Roughly 80% of core real estate's total returns come from this steady income, more than public real estate or equities, with the remainder coming from appreciation (or the increase in the value of a property over time). Though accounting for less than a quarter of core real estate total returns, appreciation is responsible for 83% of annual volatility (as external factors beyond manager control, such as inflation, tenant demand or capital availability) (Figure 3). An asset class that derives more returns from income rather than appreciation tends to have a stabilizing effect in mixed-asset portfolios.

FIGURE 3

Share of Total Returns and Volatility from Income and Appreciation, 1978 - 2022



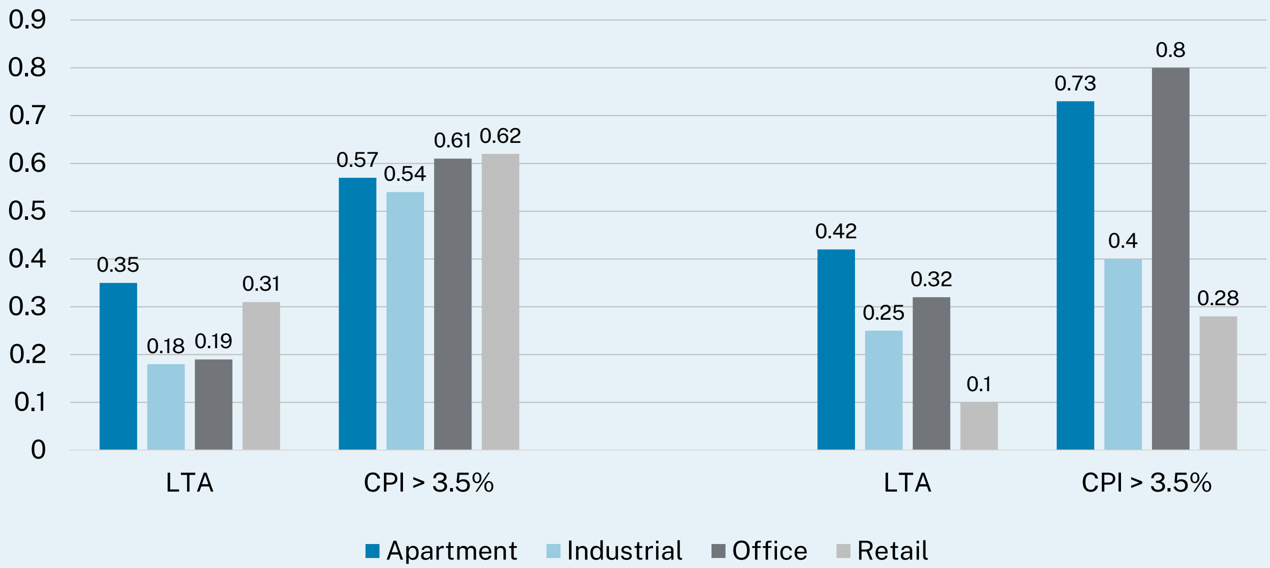
Source: American Realty Advisors based on data from NCREIF as of May 2023. Equities are represented by the S&P 500. Public real estate is represented by the FTSE Nareit All-Equity REIT Index. Private real estate is represented by the NFI-ODCE. LTA = long-term average, 1978 – 2022.

Hedge Against Inflation

Inflation has recently re-emerged as a concern for investors and its corrosive effect on real returns means investors pose a challenge for nominally priced assets. Real estate on the other hand can benefit from inflation that can increase the cost of building materials, labor, and other inputs to constructing or maintaining real estate. This can lead to an increase in the value of existing assets, as it becomes more costly to build new ones. Less supply and rising costs then may allow owners to increase rents and in turn, income returns. While there may be other factors at play, during certain periods where inflation was higher, both income and total returns have increased (Figure 4).

FIGURE 4

Correlation Between Inflation and Private Real Estate Income, Total Returns, LTA and CPI > 3.5%



Source: American Realty Advisors based on data from NCREIF as of May 2023. LTA = long-term average, 1978 - 2022 for both NPI and CPI-U Less Food and Energy, Seasonally Adjusted.

Enhanced Portfolio Diversification

Diversification allows plans to spread their investments across a range of asset classes to minimize overall portfolio risk by reducing the impact of any singular investment class. Real estate has historically demonstrated a low correlation to both stocks and bonds, providing a counterbalance in times when one or more may be underperforming (Figure 5). Core funds also have the added benefit of offering further diversification through holdings in different sectors and markets; if local conditions change in one area, another market may be entirely unaffected.

FIGURE 5

Correlation Between Private Real Estate and Other Portfolio Investments

Correlation Coefficient 2000-2022	Private core real estate	Public real estate	Equities	Bonds
Private core real estate	1.00			
Public real estate	0.22	1.00		
Equities	0.11	0.65	1.00	
Bonds	0.09	-0.09	-0.17	1.00

Note: Equities are represented by the S&P 500. Public real estate is represented by the FTSE Nareit All-Equity REIT Index. Private real estate is represented by the NFI – ODCE. Bonds are represented by the market yield on U.S. Treasury Securities at 5-Year Constant Maturity.

Source: American Realty Advisors based on data from NCREIF Fund Index – Open End Diversified Core Equity (NFI-ODCE), FTSE NAREIT, Macrobond and FRED St. Louis as of May 2023.

Conclusion

Real estate has long left behind its old identity as an “alternative” asset class and in most portfolios stands shoulder to shoulder with equities and fixed income. While in a rapidly changing market, environment a more illiquid asset class such as real estate may pose challenges to maintaining strict portfolio allocations, it also reinforces the importance of having a long-term investment perspective and the folly of trying to market time intermediate term market fluctuations.

Core real estate continues to evolve — investors now have more choices to build successful portfolio strategies while still enjoying relative stability and predictable income streams, inflation-hedging properties, and portfolio diversification enhancement.

The fundamental benefits of core real estate have remained consistent over time and looking ahead, opportunities for investors will continue to evolve, shaped by technological advancements, changing work and living patterns, and broader economic trends. Although no one has a crystal ball or clear vision into the future, experienced managers with creative strategies that embrace the changing landscape will be best positioned to navigate this evolving market. Successful investing is not necessarily about predicting the future; it is about preparing for it and having the insight to capitalize on market changes to achieve long-term investment goals.

DISCLAIMER

FORWARD-LOOKING STATEMENTS

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