Those balmy days of summer

Beware the fall

by Randall and Matthew Zisler

With the welcomed arrival of summer, receding memories of 2008 and the ongoing recovery, we are filled with excitement and hope for the future. Now, maybe, is the time to review what we may not know, or may have forgotten, about real estate, and revisit its place within a multi-asset portfolio.

We offer on this balmy day some stylized facts about real estate.

- Real estate is no one-size-fits-all Platonic investment alternative. In fact, it is so heterogeneous that the term "asset class" seems to hide more than it reveals and even defies logic. It is highly differentiated with regard to performance by property type, MSA, region, lease structure, position in the capital stack and other characteristics.

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- Real estate's extreme dimensionality makes asset allocation exercises (how much real estate makes sense in a multi-asset portfolio?) even more challenging. Such is also the case with so-called alternative assets. The term "alternative asset" seems like an afterthought after accounting for traditional stocks, bonds and cash, or maybe it is a name for something we do not understand.
- Real estate has option- and bond-like characteristics, which are easy to ignore but nevertheless very real. For example, medical office buildings are very bond-like and their leases have low default rates, such that they resemble AAA or AA corporate debt with junk bond pricing. Another example is a vacant urban lot with development potential; it is a call option, the strike price of which equals the sum of the hard and soft development costs. The option's value increases with market volatility; it has time value as well. Unfortunately, many analysts ignore embedded options.
- Neither REITs nor property are good inflation hedges. A three-year rolling correlation of REITs or property (unleveraged NCREIF) returns with inflation reveals a low correlation with inflation, but this should not be surprising. Property appears to be an inflation hedge during those few times when vacancy rates are abnormally low and inflation is high. (Note that, accordingly, real estate was a perfect hedge in 2008 when property returns plummeted as the economy deflated.)
- REITs perform as stocks. When we include REITs as an asset alternative within an asset optimizer that includes the S&P 500 Index as a choice, REITs replace S&P 500, indicating that REITs perform more like a stock than property.
- Cap rates are loosely correlated with bonds or T-Bills. That is why we do not agree that cap rates will necessarily rise (or prices fall) should interest rates increase. Cap rates are a function of the risk-free rate and the credit spread, less the expected growth of net operating income or cash flow. In fact, cap rates could conceivably fall with rising interest rates if a strong economy narrows credit spreads and investors expect strengthening real estate performance. Rolling correlations of property returns with long-term government bonds reveals no consistent relationship between bond and property returns.

- Investors are eying so-called secondary cities. We have long advocated that secondary should be primary even though 70 percent of institutional property investments reside within the top six MSAs. Many investment managers, especially those under pressure to invest large amounts of capital within a compressed timeframe, claim secondary cities are fraught with risk. Specifically, the exit at sale is impaired by lack of liquidity. We question whether there is a rational basis for this claim. If there is a liquidity discount, what is that discount and do prices already reflect the discount?

- Risk is multidimensional and at times all too elusive to measure accurately. For example, investors often think of risk too narrowly. It is more than lease default risk. For example, a fully leased, relatively new office building with AAA long-term leases and purchased at a less than 5 percent cap rate may have substantial exit cap rate risk, especially given the variability of cap rates over time.

So, if property is not an inflation hedge, is there still a role for property within a multi-asset portfolio, and how do we determine this role? We are excited to report that, indeed, there is a role, and this role is robust over a wide range of assumptions. With the usual caveats about models and the use of historical return data, we proceed.

Asset allocations can vary depending on whether we include or exclude liabilities. First consider asset-only allocation. Property plays a role because the correlation of property with other assets is low. Modern portfolio theory exploits this low to negative correlation by constructing multi-asset portfolios that maximize total return for every level of risk. We find that property receives an allocation along most of the entire efficient frontier, from most conservative to most aggressive.

Property added to an equally weighted portfolio of non–real estate assets improves performance by increasing return (without additional risk) or by reducing risk without sacrificing return. Suboptimal aggressive as well as conservative portfolios benefit with the addition of property. Diversification is a true free lunch. When located on the efficient frontier, investors increase return by incurring more risk. Wealth grows faster with the addition of property.

What happens when we include liabilities? Liabilities come in many flavors. Liability structures vary significantly by investor class, such as pension fund, endowment and high-net-worth individual, and within any single class. In fact, modeling the liabilities may be more challenging than modeling the assets. Asset allocation as seen from the perspective of the liabilities is critical because a low-risk asset, such as cash, can be a high-risk asset if the liabilities resemble in their expected performance equities or bonds. Property, as modeled using the unleveraged NCREIF Property Index, receives an allocation along most of the entire efficient frontier for either equity- and bond-like liabilities.

As with many other so-called investment classes, especially some of the more exotic and private market choices such as venture capital and private equity, we lack adequate performance indexes. For instance, unleveraged real estate returns are not the ideal proxy for a high-net-worth individual who invests in the LP position of a leveraged, highly structured value-added or development deal. Consequently, investors should review asset allocation studies with a critical, discerning eye.

Most investors do not like losing money. That is why managing downside risk or shortfall is essential. A shortfall constraint specifies that the portfolio return must exceed a minimum value for any given level of portfolio risk, confidence level and return threshold. Even under onerous shortfall constraints, property plays a role in a well-diversified multi-asset portfolio. Investors can specify a minimum return threshold and the probability of breaching the threshold. The shortfall constraint excludes higher volatility portfolios along the efficient frontier because the efficient frontier to the right of the intersection of the shortfall constraint with the efficient frontier includes portfolios with higher standard deviations that present a heightened probability of breaching the minimum threshold. The lower the probability of breaching the minimum return or shortfall constraint, or the higher the threshold, then the fewer are the riskier investment opportunities along the efficient frontier.

We often focus on deal-level risk: a value-added or opportunistic deal, in isolation, may appear riskier than a core or core-plus deal. However, the incremental asset when added to a portfolio, even an apparently riskier asset, can reduce overall portfolio risk without sacrificing return, especially in the light of certain liabilities. The marginal risk is then negative. Just as Treasury bills appear riskier in the context of certain liabilities, value-added and opportunistic deals can reduce overall portfolio risk without sacrificing surplus return, and thereby increase the value of the surplus.

As fear recedes, investors grow greedy and property prices ineluctably strengthen with the rising sap. Hope springs (perhaps neither eternally nor consistently), but beware the hidden dark side. Now is the time to question the received wisdom and cast a discerning eye on risk and its prudent management. ❖

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