Real Estate

The value of commercial real estate in volatile times

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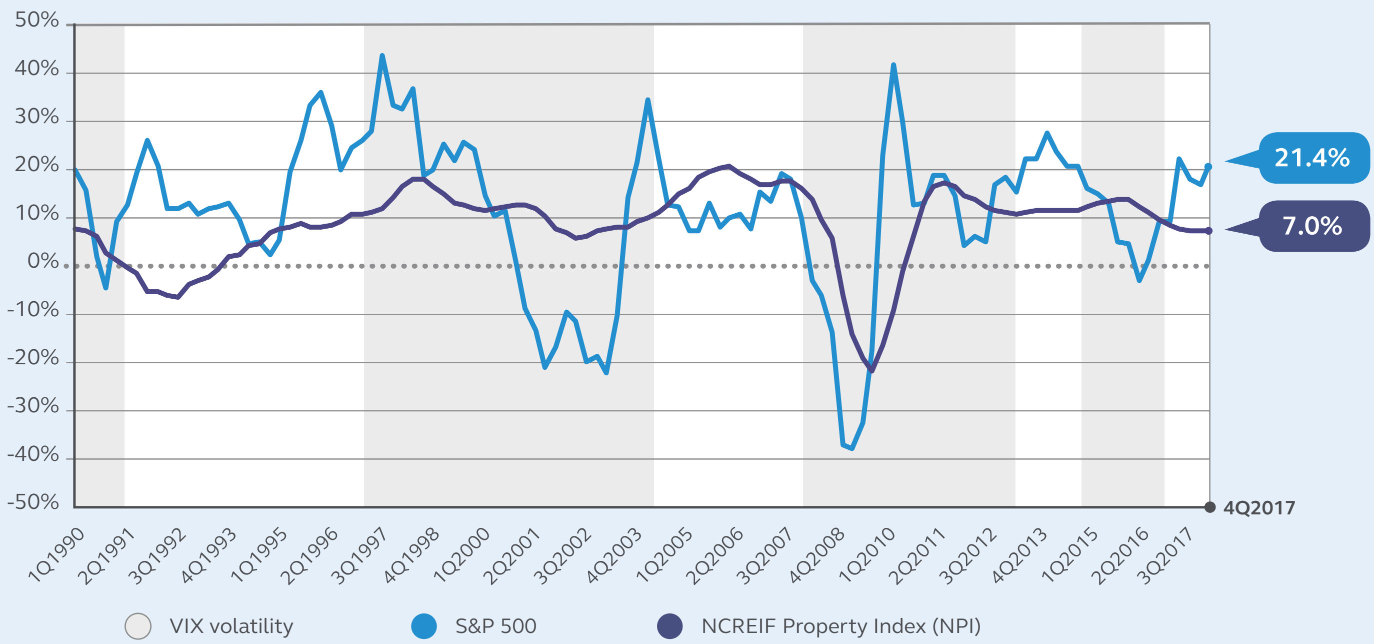
> "History has shown time and again that an allocation to private real estate has helped investors at precisely the point they have needed it most in terms of diversifying some of their risk."

The past couple of weeks smashed the spell of complacency global investors have enjoyed for the last two years and served as a reminder that risk assets, by their very definition, embody risk. Stock market volatility, as measured by the VIX index, has jumped by 242% in the past month, suggesting that a period of remarkably low volatility may be over. Highly accommodative global monetary policies engineered by the U.S. Federal Reserve and the European Central Bank have largely been responsible for the dampening of risk; now that monetary policies are re-normalizing and inflationary expectations are rising, risk has returned to the table.

Moments of market volatility are timely reminders for investors to re-consider some of the potential benefits of adding private commercial real estate to their portfolios. History has shown time and again that an allocation to private real estate has helped investors at precisely the point they have needed it most in terms of diversifying some of their risk. As can be seen in the chart below (Exhibit 1), real estate has offered a relatively smooth history of investment performance when compared with equities as well as with VIX index.

Exhibit 1: Average annual total return

1990 - Fourth quarter 2017



Sources: National Council of Real Estate Investment Fiduciaries (NCREIF), Standard & Poors (S&P), SIX Financial Information, Principal Real Estate Investors, February 2018

More importantly, the lower beta of private real estate (a risk measurement identifying that private real estate is less volatile than the market as a whole) is even more pronounced during times of market volatility, which is what matters to investors (see Exhibit 2). The inverse correlation between the VIX Index and the S&P 500 Index indicates that when volatility has spiked, stocks have fallen. During those same periods of high volatility, commercial real estate values have fallen much less, providing investors with the dampening mechanism critically needed during such times.

Exhibit 2: High volatility periods correlations

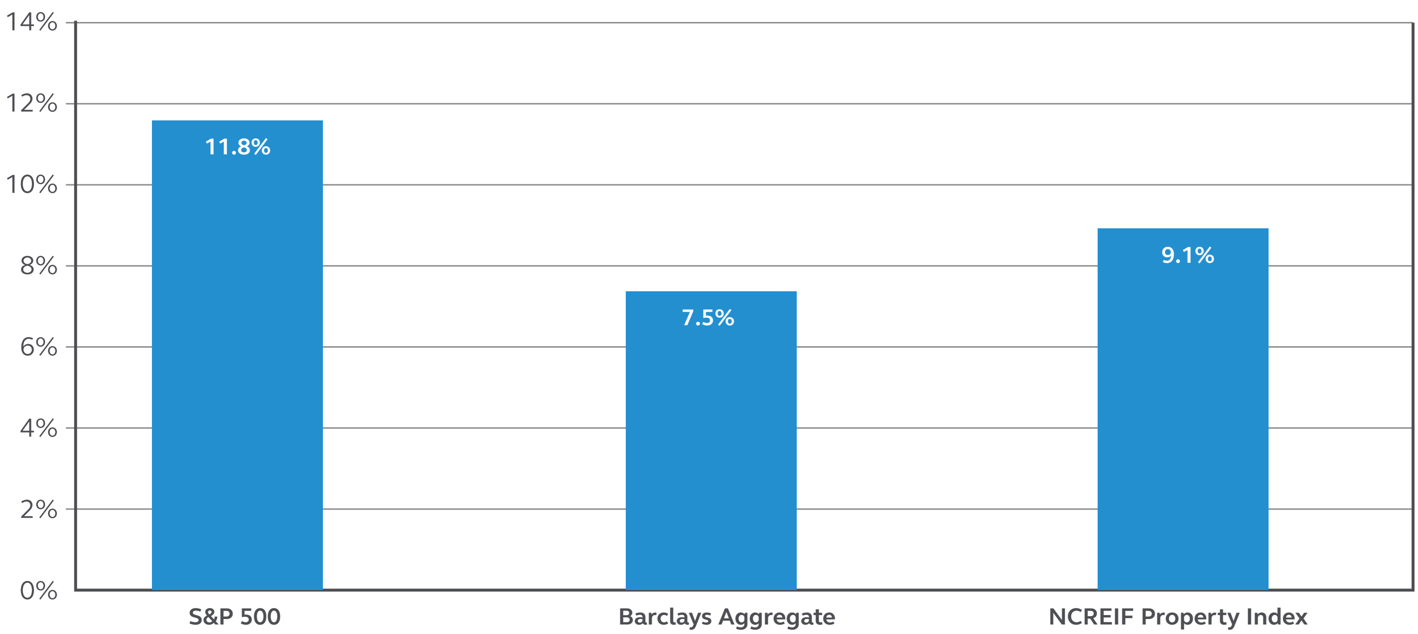
	VIX	S&P 500	NPI
VIX	1		
S&P 500	-0.605	1	
NPI	-0.180	0.422	1

Sources: NCREIF, Standard & Poors, SIX Financial Information, Principal Real Estate Investors. The periods of high volatility used in the calculation were: 1Q 1990 - 4Q 1991, 1Q 1998 - 4Q 2000, 1Q 2002 - 4Q 2004, 1Q 2008 - 1Q 2010.

While private commercial real estate can dampen volatility, it has also historically provided investors with steady investment performance over the past three and a half decades. In terms of absolute returns, private real estate performed in between equities and bonds, as seen below (Exhibit 3). Additionally, private real estate can prove even more attractive if viewed from the lens of risk-adjusted performance given the lower comparative volatility (beta) of the asset class.

Exhibit 3: Average annual total returns

1978 - Fourth quarter 2017

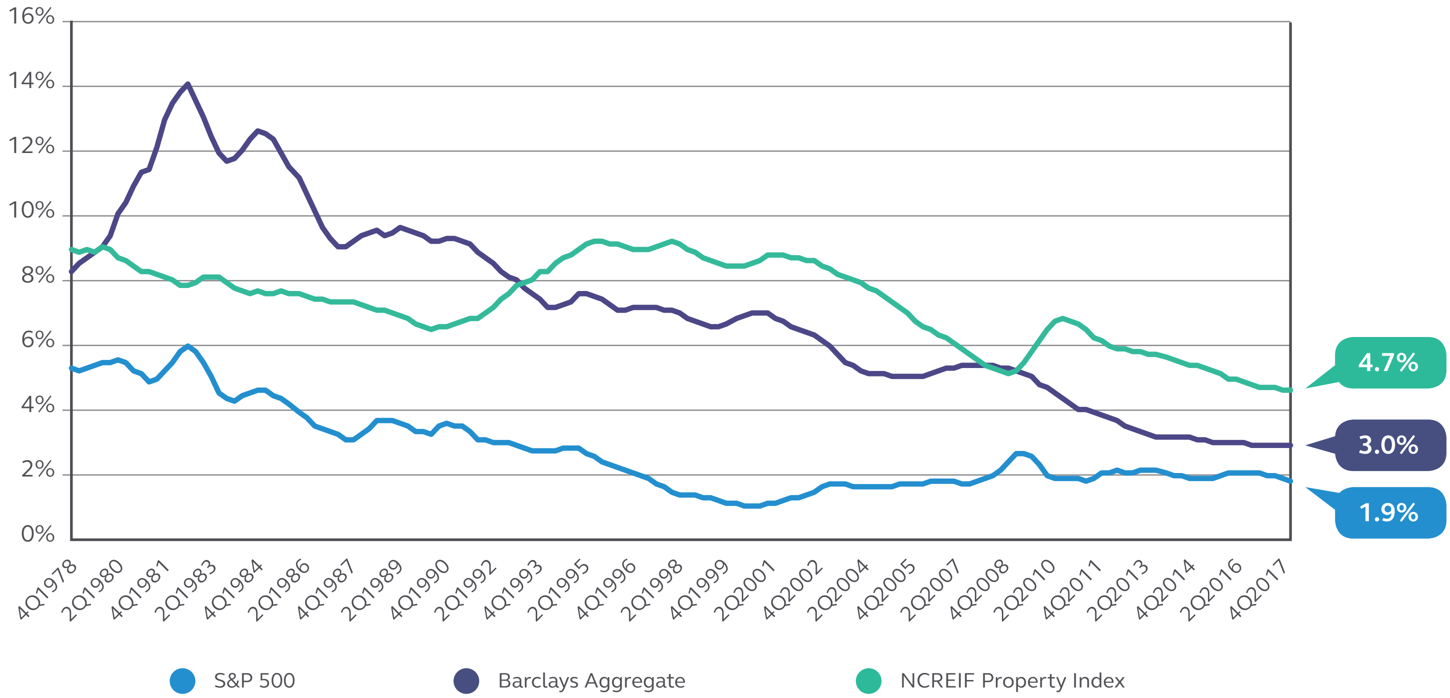


Sources: NCREIF, Standard & Poors, Barclays Capital, Inc., February 2018

Notably, real estate has delivered a consistent stream of income – an important consideration for investors who value cash flow. Much of the income return is derived from rent that is passed on to landlords; rent growth has averaged 3-4% over the past few years (see Exhibit 4). Looking ahead, Principal Real Estate Investors forecasts that rent growth is likely to slow but remain positive in the 2+% range for the four major property types, as occupancies remain stable. At a time of global volatility, predictability of income returns becomes an important attribute.

Exhibit 4: Average annual income return

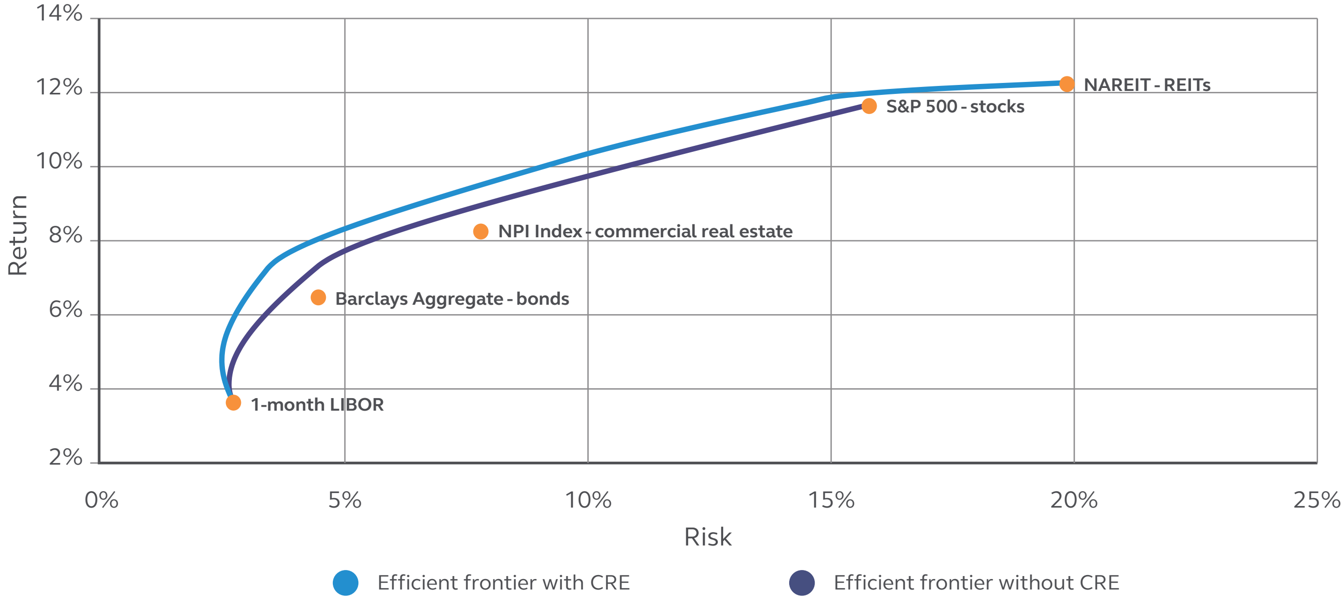
1978 - Fourth quarter 2017



Sources: NCREIF, Standard & Poors, Barclays Capital, Inc., February 2018

The return of volatility is a timely reminder for investors on the many uses for commercial real estate in a multi-asset portfolio. The lower risk and realized volatility that commercial real estate has delivered is another important consideration in the creation of optimal portfolios. When commercial real estate index returns are fed into an optimizer, the results suggest improved diversification and, hence, greater return per unit of risk (see Exhibit 5 below).

Exhibit 5: Commercial real estate (CRE) provides diversification and opportunity for greater return per unit of risk



The efficient frontier illustrates a hypothetical portfolio from a model. The model is based on historical data from the period 1Q 1987 - 4Q 2017. Sources: ICE Benchmark Administration Limited (LIBOR), Barclays Capital Inc. (Barclays Aggregate), NCREIF (NPI Index), Standard & Poors, National Association of Real Estate Investment Trusts (NAREIT), Principal Real Estate Investors, February 2018.

Conclusions

U.S. commercial estate allows multi-asset investors access to an asset class that can provide diversification benefits along with a steady stream of income at times when it is needed most. The surge in recent market volatility, along with a heightening of correlation amongst risk assets, is a timely reminder of the value of private real estate with its beta dampening abilities.

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