GLENMEDE

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Sizing Up Real Estate in Portfolio Construction

Introduction

In today's global capital markets, many assets are priced above what we consider to be their long-term fair value and trade at valuations well in excess of historical averages. Most assets have re-rated (i.e., recovered a majority of price decline or even above pre-COVID levels) as the global economy continues to improve, especially in the U.S. However, there are still a few areas where the re-rating process has lagged and valuations appear fair and reasonable. One such asset class is real estate.

We believe clients who have the ability and willingness to include this asset class in their portfolio construction should consider redirecting a portion of their capital to real estate, which historically has delivered a benefit to overall portfolio risk-adjusted returns. Building competitive and efficient portfolios includes the incorporation of asset classes exhibiting complementary characteristics (e.g., low correlations) and the flexibility to opportunistically allocate toward areas of the market that appear mispriced, either in absolute or relative terms.

Features of real estate

Glenmede views real estate as a fundamental component of investment portfolios that historically has provided a form of "ballast" during periods of uncertainty, rising interest rates and inflationary market regimes. While certainly not a bond, real estate can offer an attractive form of income, especially in an environment characterized by low absolute yield and negative real yield (i.e., yield after compensating for the effects of inflation). Although real estate's total return has a heavy income component, it also offers the opportunity for capital appreciation.

Outside of a primary residence or multiple residences, many investors view real estate through the relatively narrow lens of publicly traded real estate investment trusts (REITs)[1]. Private and non-traded real estate[2] is often overlooked since many consider this to be accessible only by large institutional and family offices. The nature of these two typologies of real estate is quite different from a risk and return perspective, and Glenmede believes there is room for both in portfolios. On this note, it's important to better understand how publicly traded (i.e., listed) and private-oriented real estate are differentiated.

Comparison of publicly traded and private/non-publicly traded real estate

Returns

Cash flows from contractual lease agreements are the primary driver of total return for both types of real estate. As a result, returns are relatively consistent over various market cycles. In theory, publicly traded REITs should yield a higher return due to their higher volatility; however, private real estate should compensate investors for less liquidity. Therefore, long-term returns are fairly similar and, over time, have tended to be superior to investment-grade bonds.

[1] *The FTSE Nareit Composite REIT Index is a free-float adjusted, market capitalization-weighted index of U.S. equity and mortgage REITs. Constituents of the Index include all tax-qualified REITs that also meet FTSE's minimum size and liquidity criteria. It is intended to be a broad representation of publicly traded U.S. real estate.*

[2] *NCREIF Fund Index - Open End Diversified Core Equity, is an index comprised of a select group of open-end commingled funds (i.e., partnerships) that employ core investment strategies, defined as being predominately income-oriented, lower return and lower risk. It is also defined as having lower financial leverage and a well-leased, stabilized and diversified portfolio of investments across multi-family housing, office, retail and industrial sectors.*

Volatility

Private real estate volatility has been materially lower than listed REITs over time, and this can be partially tied to three reasons:

- Private real estate, being less liquid, typically has less frequent transactions and appraisals, which are used to determine valuation.
- Listed REIT volatility can be a reflection of broad market sentiment and overall equity capital flows.
- Listed REITs tend to employ larger amounts of financial leverage, which can amplify results.

Risk-adjusted returns

Taking into account the aforementioned return and volatility characteristics, it's not surprising that private real estate generates better risk-adjusted returns over the long term. Over an average market cycle, private real estate normally exhibits better Sharpe Ratios, Sortino Ratios and return asymmetry. Please see data in Exhibit 1 which reflects some summary statistics for each type of real estate.

Sharpe Ratio	The ratio of return to risk; generally, the greater the value of the Sharpe ratio, the more attractive the risk-adjusted return. Penalizes for both upside and downside volatility.
Sortino Ratio	A variation of the Sharpe ratio; focuses on the distribution of returns that are below the target or required return. Penalizes only for downside volatility.
Return Asymmetry	Degree of up-market capture relative to down-market capture.

Exhibit 1: Private real estate offered better risk-adjusted returns than listed REITs

	Private Real Estate	REITs	80% Private Real Estate / 20% REITs	70% Private Real Estate / 30% REITs	60% Private Real Estate / 40% REITs
Average Total Return	**7.8%**	10.3%	8.7%	9.1%	9.4%
Standard Deviation	**6.3%**	19.9%	7.1%	8.2%	9.6%
Sharpe Ratio	**0.97**	0.44	1.00	0.91	0.81
Sortino Ratio	**1.31**	0.61	1.33	1.21	1.10
Return Asymmetry (vs. S&P 500)	**50%**	16%	46%	44%	43%
Return Asymmetry (vs. ACWI)	**51%**	22%	48%	47%	46%

Source: eVestment
Data for the period January 1, 2000 - December 31, 2020. The indexes represented are as follows: U.S. private real estate (NCREIF Fund Index-Open End Diversified Core Equity (NFI-ODCE), REITs (FTSE NAREIT U.S. Real Estate Composite Index). Quarterly re-balance is assumed for the private real estate and REITs portfolios. Performance over different time periods may have been less favorable than shown above. It is not possible to directly invest in an index. Performance for indices does not reflect investment fees or transaction costs. Standard deviation is based on quarterly returns. Risk free rate is 3-month T-Bill.

Diversification

Diversification is a primary reason for including real estate in portfolios. Exhibit 2 demonstrates the low correlation that private real estate has with stocks and bonds, making it an especially beneficial asset to overall portfolio construction. While the correlation of listed REITs with stocks and bonds is higher relative to private real estate, it is differentiated enough to still provide a benefit. Also interesting is the low correlation between private and listed REITs, which points to their complementary nature and underlines that both can play a role in the portfolio. One note of importance is that investors should not consider investing in an asset just because it has a low correlation with other portfolio components and thus is a good diversifier. The asset should also exhibit a reasonable real rate of return, after taking into account both taxes and volatility.

Exhibit 2: Correlations between U.S. real estate, bonds and stocks (2000 - 2020)

	Private Real Estate	REITs	Stocks	Bonds
Private Real Estate				
REITs	0.18			
Stocks	0.11	0.69		
Bonds	-0.15	0.05	-0.34	

Source: eVestment
Data for the period January 1, 2000 - December 31, 2020. The indexes represented are as follows: U.S. private real estate (NCREIF Fund Index-Open End Diversified Core Equity (NFI-ODCE), REITs (FTSE NAREIT U.S. Real Estate Composite Index), Stocks (S&P 500), Bonds (Bloomberg Barclays U.S. Aggregate Bond Index). Performance over different time periods may have been less favorable than shown above. It is not possible to directly invest in an index. Performance for indices does not reflect investment fees or transaction costs.

Liquidity

Listed REITs have an advantage from a liquidity perspective, with most allowing for daily liquidity. Private real estate and non-publicly traded REITs have less frequent liquidity intervals, ranging from quarterly, semi-annual and annual. Using listed REITs can provide benefits for portfolio rebalancing or tactical asset allocation, which is difficult to implement if one is working entirely with private-oriented real estate. When the time comes to tilt away from real estate and toward a more attractive investment opportunity, listed REITs provide the liquidity to do so.

Taxes

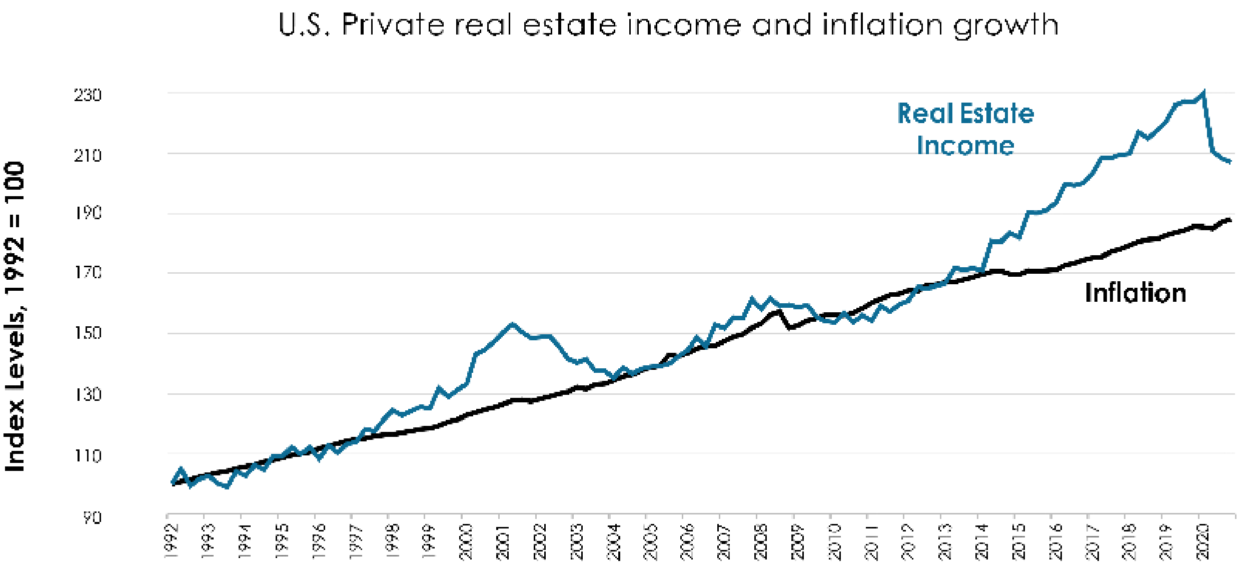
Companies must meet several criteria to qualify as REITs under the U.S. tax code. For example, the REIT must distribute at least 90% of its taxable income to shareholders. As a result, most of the income is taxed at the investor level as ordinary income, though there may be some elements of capital gain or return of capital. For most publicly traded REITs, most of their distributions are taxed as ordinary income.

Private real estate and non-traded REITs can have a sizable portion of their distribution "shielded" by depreciation. This shielded portion of the distribution is characterized as a return of capital and thus is not taxable. The investor will ultimately pay taxes on the distribution, but the distribution will be characterized as long-term capital gain when the physical property is sold or the real estate investment is liquidated. In short, non-publicly traded REIT strategies have the potential to deliver better tax-adjusted income for taxable investors.

Real estate in inflationary environments

Historically, commercial rents and property values have been correlated with rising prices. As a result, real estate has done a good job keeping pace with or exceeding inflation, though at times with a lag as leases catch up to reflect market prices. Exhibit 3 shows one example of how net operating income has grown relative to inflation over time.

Exhibit 3: Real estate net operating income (NOI) has outpaced inflation since 1992



Based on CPI Inflation. Real Estate Income is same-store NOI growth
Sources: JLL, Bureau of Labor Statistics, NCREIF. JLL Data as of 4Q 2020. Most recent as of March 2021.
Note: Past performance is not indicative of future results. There is no guarantee that any trends shown herein will continue.

Conclusion

Real estate can be a good complement to multi-asset portfolios based on its potential diversification benefits, lower volatility relative to stocks and bonds and relatively attractive risk-adjusted returns and income attributes. It's important for investors to understand the differences between private real-oriented estate and listed REITs. Glenmede believes utilizing private real estate and listed REITs in portfolios likely will yield better results than just choosing one to play a solo role.