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Real Estate's Value in Portfolios: Go Private When Possible

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With the market volatility over the past year and a half, investors are speculating when the markets might exhibit a deep, prolonged correction.

Last year, from September 18, 2018 through December 24, 2018 the S&P 500 Index declined almost 20 percent. The year-end pullback was a stark contrast to previous years' low volatility investors have come to expect. It's safe to assume investor expectations for volatility has increased during 2019 after a choppy start to the year.

The euphoria from the Tax Cuts and Jobs Act of 2017 has waned and the markets face uncertainty corresponding with a U.S.-China trade deal. Now, it's not a question of if, but when, we'll see a bear market.

During the 2019 first quarter meeting cycle, DiMeo Schneider's clients discussed portfolio asset allocation when many came to the same conclusion; domestic growth stocks won't always shine, and technology companies won't always outperform.

Diversified portfolios provide the greatest balance of risk and return over the long-term. The importance of real assets within portfolios cannot be ignored during periods of heightened market volatility. Assets, including oil and housing, are tangible and important to most everyone's daily lives. Additionally, investors can invest in real estate through either public or private markets.

When constructing a portfolio at this point in the market cycle, it's important to maintain or stretch allocations to real estate.

1. Over the past few months, the Federal Reserve has taken a dovish tone, that helps maintain real estate valuations and soften downward pressure on prices. Generally, low interest rates and easy access to credit correlates to increased demand for real estate investments. St. Louis Federal Reserve president, James Bullard, stated earlier this month, an interest rate cut "may be warranted soon". In March, Reuters' poll of economists cited a 40 percent chance of at least one rate cut by the end of 2020. Coupling the two data points, it seems likely any future action by the Federal Reserve would be a rate cut.
2. Although Gross Domestic Product (GDP) expansion has slowed, the economy continues to grow. Real estate growth and price acceleration tends to move in lockstep with broader economic growth (or lag slightly). Recently, the Federal Open Market Committee (FOMC) released economic projections for real GDP growth rates. In 2019, the FOMC projects 2.1 percent growth, 1.9 percent in 2020 and 1.8 percent in 2021. Domestic growth rates near two percent should help propel income growth for commercial real estate.
3. Supply of new construction or signs of overbuilding are below pre-recession levels. Commercial construction percentage of GDP is below its long-run average and has been below average since 2008. Therefore, current commercial real estate prices should not face pressure from new supply coming to market.

When considering investing in real estate it's important to determine the liquidity needs of the portfolio. If an investor's able to withstand the liquidity constraints of private real estate and its seven to 10-year investment time horizon, private markets present a lower correlation to public equity markets and a better risk and return profile over a full market cycle.

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However, if the liquidity needs are greater and the portfolio does not have a perpetual life, then public real estate (Real Estate Investment Trusts i.e. REITS) should be utilized. Liquidity requirements are not the only deciding factor when making an investment in private or public real estate. Private real estate investments generally require commitment amounts that exceed $1 million. To maintain vintage year, style and geographic diversification within a real estate sub portfolio, private real estate investing usually requires a $5 million allocation of portfolio assets. Private real estate, therefore, may not be feasible for some investors.

Historically, return correlations between real estate (both public and private) and equity markets, represented by the S&P 500, have been quite low (see chart below). And, when measured on an absolute and risk adjusted basis over the last 40 years, private real estate has outperformed domestic equity markets over the full cycle (reference chart below).

Correlations, Last 40 Years			
	Private Real Estate	Public Real Estate	S&P 500 Index
Private Real Estate	1.00		
Public Real Estate	0.16	1.00	
S&P 500 Index	0.08	0.60	1.00

Note: Private Real Estate = NCREIF Property Index, Public Real Estate = FTSE NAREIT Equity REIT Index

Risk & Return Statistics, Last 40 Years (Annualized)			
	Private Real Estate	Public Real Estate	S&P 500 Index
Return	9.4%	5.1%	9.0%
Risk (σ)	4.1%	17.3%	15.5%
Sharpe Ratio	1.8	0.2	0.5

Note: Private Real Estate = NCREIF Property Index, Public Real Estate = FTSE NAREIT Equity REIT Index

In summary, allocations to real estate are important at this point in the market cycle. Real estate allocations provide diversification and positive (or in some cases, additive) risk adjusted returns. Furthermore, if an investor can tolerate some illiquidity within an investment portfolio and the portfolio allocates more than $5 million to real estate, private real estate offers the most compelling option.

For more information, please contact any of the professionals at Apollon Wealth Management, LLC

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