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Private Real Estate: Unlocking Opportunity Beyond Stocks and Bonds

By Franklin Templeton Academy

INVESTMENTS & WEALTH INSTITUTE®

Private Real Estate

UNLOCKING OPPORTUNITY BEYOND STOCKS AND BONDS

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Private real estate has long been prized by family offices and institutional investors for its historical investment characteristics: durable income, competitive returns, inflation hedging, and portfolio diversification. A recent UBS survey of more than 220 family offices found the average allocation to real estate was 12 percent (see figure 1).[1]

Among institutional investors, the average allocation ranges from 5 percent to 9 percent, depending on the segment, with pension plans holding the largest allocations.[2] The California State Teachers' Retirement System plan, one of the largest public pensions, goes further. As of the end of April 2022, the plan's real estate allocation totaled roughly 15 percent, with holdings diversified by property type as well as by geography.

With this level of allocation, it's not surprising that real estate represents the third-largest asset class in the United States, with nearly $11.2 trillion in assets under management (AUM), after U.S. fixed income ($47.2 million) and U.S. equities ($40.7 trillion).[3] About 90 percent of that $11.2 trillion is private real estate, i.e., properties owned by private investors, primarily commercial real estate including distribution centers, multifamily dwellings, and office complexes.

MULTIPLE AVENUES OF RETURN

Private real estate features diverse opportunities across a wide range of commercial property sectors and regions that may behave differently in response to macro conditions, thereby creating opportunities for actively managed real estate investors (see table 1).

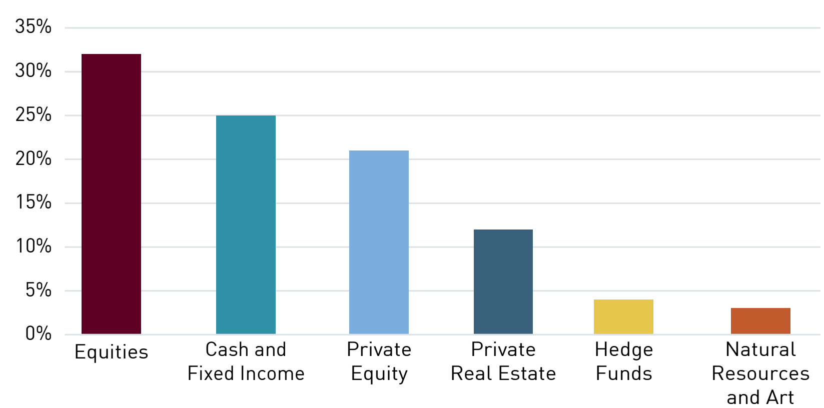
KEY TAKEWAYS

- Private real estate is a significant portfolio allocation for family offices and institutional investors.
- The asset class historically has delivered attractive distribution rates and risk-adjusted return, an inflation-resistant income stream, and portfolio diversification—outcomes that resonate in today's market environment.
- Opportunities for individual investors have expanded with the introduction of registered funds (interval and tender-offer) that offer daily valuation and greater liquidity.

Figure 1

AVERAGE FAMILY OFFICE ASSET ALLOCATION BY ASSET CLASS

As of December 31, 2022



Source: Global Family Office Report 2022, UBS

The impact of COVID-19 during the past two years provides a clear illustration. The industrial sector benefited tremendously from the rapid expansion of e-commerce during lockdowns, thanks to increased demand for large-scale fulfillment centers near major metro areas. In 2021, the market absorbed 432 million square feet of industrial warehouse space, the highest annual level on record.[4] In contrast, the office sector notably was challenged by the switch to work from home and uncertainty about when and how workers might return.

There are more general differences as well. For example, demand for office and retail properties tends to track changes in economic growth and consumer spending, but demand for multifamily housing tends to be influenced more by population and social trends. Indeed, the multifamily housing sector has benefited greatly from increased household formation in the wake of the COVID-19 lockdowns and the affordability challenges across all residential housing formats. Demand in 2021 eclipsed the previous record by more than 60 percent.[5] Similarly, purpose-built properties for the life sciences have been in solid demand thanks to an aging U.S. population, rising healthcare spending and employment, and a rapid increase in research and development (R&D) funding.

These differences help explain why the total return for various property types can vary significantly from year to year, as shown in table 2.

It's no surprise that the best-performing real estate subsectors can vary materially from year to year. Shifts in relative performance reflect a variety of factors, both financial and cultural. Multifamily and retail were the strongest-performing segments early in the 2010s, yet by the end of the decade industrial led the way in total return, buoyed by surging demand for distribution centers and for life sciences R&D facilities serving the expanding healthcare industry.

ATTRACTIVE INVESTMENT FUNDAMENTALS

Private real estate is valued by institutions and high-net-worth investors in part because of what it may contribute to a portfolio: attractive income, solid risk-adjusted returns, and effective diversification relative to a traditional stock-and-bond portfolio.

For all property types, rent payments from leases represent the primary driver of income. Commercial leases tend to be long-term and capital-intensive, with protections for landlords against early termination. Multifamily and industrial leases in particular tend to have more frequent adjustments to rents. The result is a durable income stream that is the primary driver of return in the asset class, complemented by the potential for appreciation in undervalued properties.

The value of that income stream is evident in historical distribution rates

Table 1

RECOGNIZING DIFFERENCES BETWEEN PROPERTY TYPES

Key considerations for investors

Multifamily	Office	Industrial	Retail
Residential buildings with multiple housing units	Office work environments	Properties dedicated to distribution, research storage, and manufacturing	Properties dedicated to the sale of goods and services
Key considerations: • High-rise, mid-rise, or garden-style • Quality level varies based on condition, location, and amenities	Key considerations: • Tenant capacity • Related amenities • Quality level varies based on location, proximity to transportation, and construction types	Key considerations: Business type • Life sciences • Warehouses • R&D facilities • Manufacturing • Flex (industrial/office)	Key considerations: Single tenant or multitenant business type • Shops • Restaurants • Banks • Gyms

Source: Franklin Templeton, Clarion Partners

Table 2

SHIFTING LEADERSHIP WITH THE ASSET CLASS

Total return for the NCREIF Property Index (NPI) and selected property types within index, 2010–2022 (%)

2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022 ytd
Apartment	Apartment	Retail	Retail	Industrial	Retail	Industrial	Industrial	Industrial	Industrial	Industrial	Industrial	Industrial
18.21	15.45	11.60	12.86	13.42	15.27	12.32	13.06	14.30	13.37	11.77	43.34	18.77
Property	Industrial	Apartment	Industrial	Retail	Industrial	Retail	Property	Hotel	Office	Apartment	Apartment	Apartment
13.11	14.58	11.24	12.32	13.13	14.87	9.05	6.98	7.57	6.60	1.82	19.91	10.62
Retail	Property	Industrial	Property	Property	Property	Property	Apartment	Office	Property	Property	Property	Property
12.62	14.26	10.71	10.99	11.81	13.33	7.97	6.17	6.85	6.42	1.61	17.70	9.35
Office	Retail	Property	Apartment	Office	Hotel	Apartment	Office	Property	Apartment	Office	Office	Hotel
11.74	13.76	10.54	10.41	11.49	13.22	7.33	6.02	6.71	5.52	1.57	6.11	6.38
Industrial	Office	Office	Office	Hotel	Office	Office	Retail	Apartment	Hotel	Retail	Hotel	Retail
9.37	13.76	9.49	9.86	11.06	12.51	6.21	5.67	6.07	3.51	−7.48	5.48	4.38
Hotel	Hotel	Hotel	Hotel	Apartment	Apartment	Hotel	Hotel	Retail	Retail	Hotel	Retail	Office
8.96	11.79	8.25	7.69	10.29	11.98	4.72	4.93	2.18	1.90	−25.57	4.23	1.51

Source: Bloomberg, as of September 30, 2022. Table displays total return for selected property sectors within the NPI (NCREIF Property Index) as well as the NPI itself. Not shown: data for hotels sector, which represents less than 1 percent of index capitalization. Past performance is no guarantee of future returns. Indexes are unmanaged and not available for direct investment.

for the asset class (see figure 2). Real estate has a record of delivering positive income; during the 10-year period ending June 30, 2022, distribution rates were well above the yield-to-worst for traditional bonds or the trailing 12-month yield for publicly traded real estate investment trusts (REITs).

The relative stability of that income has helped to support superior risk-adjusted returns for private real estate relative to the S&P 500 and publicly traded REITs (see figure 3).

Commercial leases typically have provisions to increase rent payments based on inflation, helping to ensure that the income streams underlying the investment keep up with rising prices. In addition, the favorable supply and demand market conditions that typify inflationary periods make it easier for landlords to pass costs on to new tenants in the form of higher rents. Both these factors have helped private real estate rents to outpace inflation during the most recent cycles, as seen in figure 4.

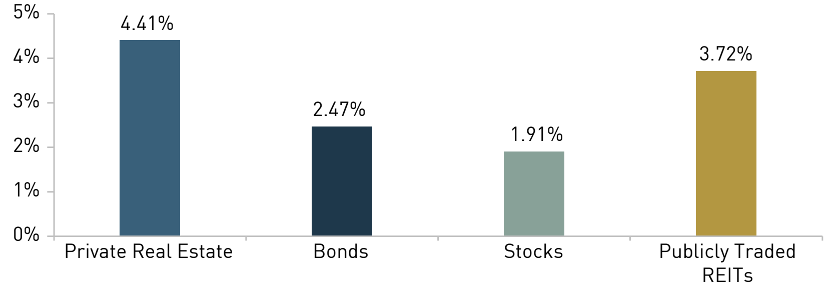
As an alternative asset class, real estate also may provide significant diversification benefits when added to a traditional portfolio. As shown in figure 5, private real estate has a significant negative correlation to both stocks and bonds. In other words, private real estate prices tend to move the opposite direction from those of both stocks and bonds.

Like any asset class, private real estate comes with distinct investment risks. Interest rates and credit availability may negatively impact the price and relative value of properties. Long-term economic and social trends and idiosyncratic events such as the pandemic also may affect demand for real estate in general as well as within specific segments. In addition, any individual property holding has the potential to be subject to adverse business conditions in its local market or region as well as to regulatory and governmental changes.

Figure 2

10-YEAR AVERAGE DISTRIBUTION RATES, JUNE 2012–SEPTEMBER 2022

Supported by contractual payments from rents and leases

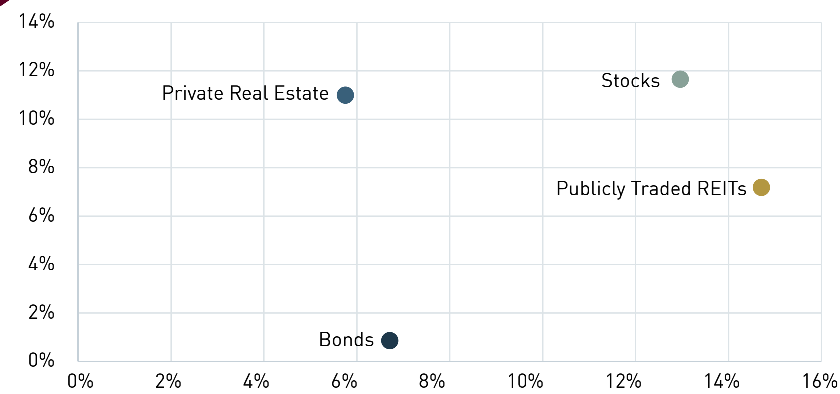


Note: The distribution rates shown are calculated using different methodologies and the comparison is shown for general illustration only.

Source: Bloomberg. Private real estate is represented by the NFI-ODCE Index. Stocks are represented by the S&P 500. Bonds are represented by the Bloomberg US Aggregate Bond Index. Publicly traded REITs are represented by the FTSE NAREIT All Equity REITs Index. Past performance is no guarantee of future returns. Indexes are unmanaged and not available for direct investment. Distributions may consist of a return of capital. Data based on historical trailing 12-month observations for dividend yield of stocks and publicly traded REITs; yield-to-worst for bonds; and 12-month income for private real estate.

Figure 3

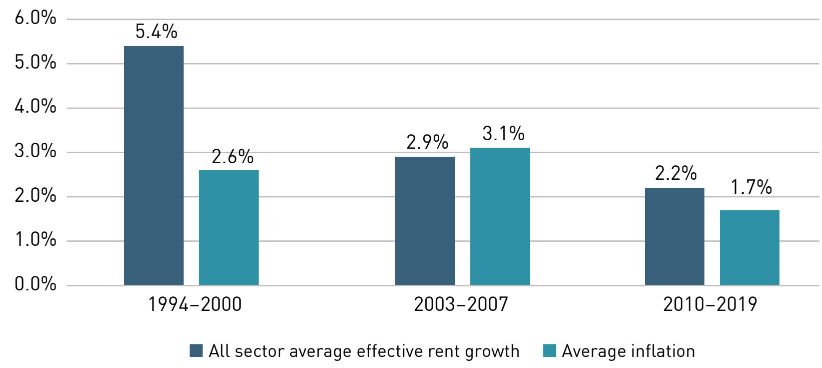
ANNUALIZED 10-YEAR TOTAL RETURN AND VOLATILITY



Source: Bloomberg. Data as of June 30, 2022. Private equity real estate is represented by the NFI-ODCE Index. Stocks are represented by the S&P 500. Bonds are represented by the Bloomberg US Aggregate Bond Index. Publicly traded REITs are represented by the FTSE NAREIT All Equity REITs Index. Past performance is no guarantee of future return. Indexes are not available for direct investment.

Figure 4

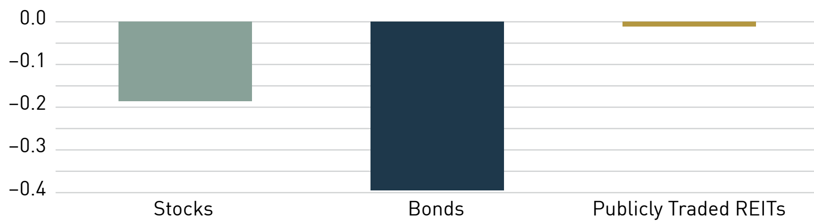
ANNUAL RENT GROWTH VS. CPI INFLATION DURING EXPANSIONARY PERIODS



Source: Bloomberg. CPI Inflation data provided by Bureau of Labor Statistics; effective rent growth data provided by CBRE. Data shown based on calendar years shown. Past performance is no guarantee of future return. Indexes are not available for direct investment.

Figure 5

PRIVATE REAL ESTATE CORRELATIONS TO STOCKS, BONDS, AND PUBLIC REAL ESTATE



Source: Bloomberg. Data is as of June 30, 2022. A positive correlation score, i.e., between 0 and 1, between two assets indicates that historically their prices tend to move in the same direction. The closer the score is to 1, the greater the effect. A negative correlation score, i.e., between 0 and −1, indicates that historically their prices tend to move in opposite directions. The closer the score is to −1, the greater the effect. Past performance is no guarantee of future results. Indexes are not available for direct investment. Stocks are represented by the S&P 500. Bonds are represented by the Bloomberg US Aggregate Index. Publicly traded REITs are represented by the FTSE NAREIT All Equity REITs Index. Private real estate is represented by the NFI-ODCE.

EXPANDING ACCESS WITH ENHANCED LIQUIDITY

Although many individual investors may have some familiarity with real estate through home ownership, private real estate investing involves many more variables and can take several forms (see table 3). Many individuals have some familiarity with REITs, a specialized vehicle that makes direct investments in commercial properties. REITs are required to distribute 90 percent of taxable income to shareholders and generally are oriented toward income generation. They may be publicly traded or privately held. Private REITs are registered with the Securities and Exchange Commission but are not covered by the Investment Act of 1940; as a result, they have more-limited investor protections and require investors to meet the wealth thresholds of an accredited investor.

Private real estate managers also take direct ownership stakes in commercial properties, with an eye on long-term appreciation as well as income generation. These investments typically involve long-term capital commitments in multiple property holdings and require specialized expertise in property valuation and management, in-depth local market knowledge, and careful monitoring of macro trends that impact credit quality and interest rates.

Private real estate investments are by nature long-term and capital-intensive. They don't focus on flipping properties for rapid gain. Rather, they focus on building value over time and generating meaningful income from tenants. A high degree of illiquidity is inherent in the asset class. As a result, traditional private real estate funds impose restrictions on the timing and scope of withdrawals, set large investment minimums of $1 million or more, and require investors to provide additional funding via capital calls as needed. In addition, participation is limited to qualified purchasers, i.e., individuals with $5 million or more in investable assets.

During the past decade, however, private real estate has been gaining greater attention from advisors and investors due to the availability of registered funds, including interval and tender-offer funds (see figure 6). These investment vehicles are formally classified as closed-end funds, but shares are continuously available to investors—unlike traditional closed-end funds, which only raise capital at the fund's inception.

Interval and tender-offer funds generally have lower minimums, enhanced liquidity, and greater transparency about holdings. Some, but not all, may limit

Table 3

REAL ESTATE VEHICLES AT-A-GLANCE

	Mutual Funds, Publicly Traded REITs	Registered Funds: Interval Funds / Tender Offer / Non-Traded REITs	Traditional Private Real Estate
Eligibility	All	All/may be restricted*	Qualified purchasers
Investments	Public and private investments	Public and private investments	Private investments
Continuous Offering	Yes	Yes	No
Daily Valuations	Yes	Yes	No
Minimum Investment	$1,000–$5,000	$2,500–$25,000	$1M–$10M
1099 Tax Treatment	Yes	Yes	K-1
Liquidity Provisions	Daily	Quarterly**	10+ Year lockup Early liquidity not available or at high redemption fees
Capital Calls	No	No	Yes

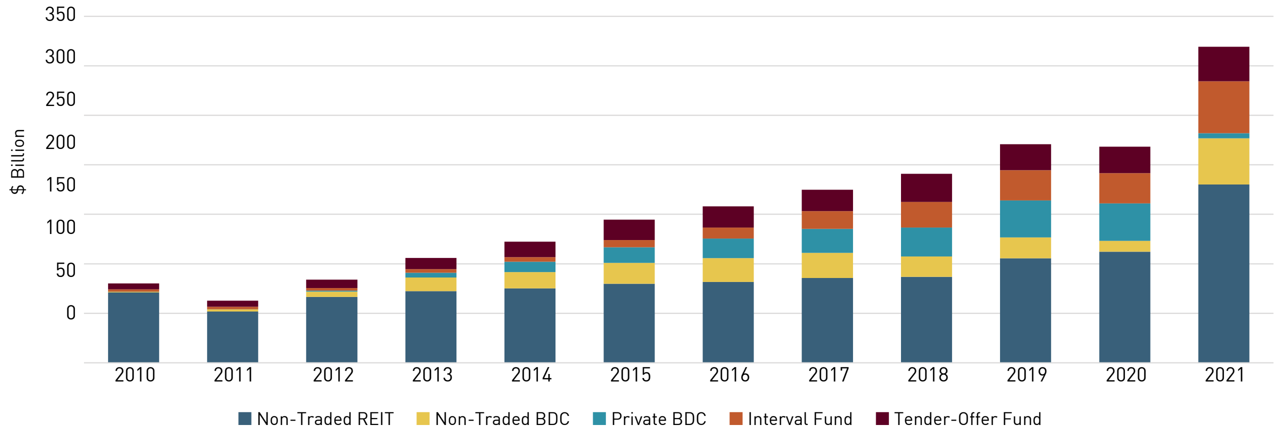
Source: Franklin Templeton, September 30, 2022.

** Eligibility restrictions may vary per broker-dealer and may require investors to be accredited investors.*

***Tender-offer and nontraded REITs typically offer quarterly liquidity at board discretion while interval funds' quarterly liquidity provisions are mandatory.*

Figure 6

REGISTERED FUNDS ARE A GROWING SEGMENT



Source: AI Insights, 2022

DEFINITIONS

Closed-end funds are a type of investment company created by the Investment Act of 1940 in which money is pooled for deployment in a specific set of assets. Many closed-end funds raise capital at inception and issue shares to investors that can be traded on public exchanges.

Interval funds are a type of closed-end fund that is not publicly traded and allows shareholders to withdraw some portion of their investment at regularly scheduled intervals.

Tender-offer funds are similar to interval funds, but with redemptions available only at the discretion of the board rather than being available on a pre-determined schedule.

Private real estate is an asset class composed of pooled private and public investments in the property markets that are not traded publicly.

Real estate investment trusts (REITs) are a specialized type of company designed to own and/or invest in real estate properties. A REIT is required by law to distribute at least 90 percent of its taxable income to shareholders. Shares in public REITs are tradable on public exchanges; non-traded REITs are privately held and may be very illiquid.

Capital calls are mandatory demands made on an ad hoc basis by private investment vehicles for additional capital from investors to support the original investment.

’40-Act funds are investment vehicles authorized by the Investment Company Act of 1940, including open-end mutual funds, exchange-traded funds, closed-end funds, and unit investment trusts.

Accredited investors are individuals with gross income of $200,000, or with joint income with a spouse or partner of $300,000 or more in each of the two most recent years.

Qualified purchasers are individuals or family-owned businesses with $5 million or more in investments, or individuals or businesses that invest $25 million or more for others, such as a professional investment manager.

CPI (Consumer Price Index) inflation is a measure of inflation calculated by the U.S. Bureau of Labor Statistics based on price changes for a hypothetical basket of goods and services.

NCREIF (NPI) is an unmanaged index of institutional property investments that reflects the performance of the real estate market in general.

NCREIF Fund Index–Open-End Diversified Core Equity (NFI-ODCE) is an unmanaged index of open-end commercial real estate funds that reflects the performance of investment real estate in general.

FTSE NAREIT All Equity REITs Index is an unmanaged index of public U.S. equity REITs that reflects the performance of the public REIT market overall.

S&P 500 is an unmanaged index of 500 U.S. stocks that reflects the performance of large-cap U.S. stocks in general.

Bloomberg US Aggregate Bond Index is an unmanaged index that reflects the performance of the investment-grade universe of bonds issued in the United States, including U.S. Treasury, government-sponsored, mortgage, and corporate securities.

participation to accredited investors. Interval funds provide quarterly liquidity and daily net asset valuations. Tender-offer funds provide similar features and benefits, but redemptions are at the discretion of the fund board, which may choose to limit redemptions.

CONCLUSION

Real estate's relevance as a potential portfolio diversifier was apparent in 2022, when fixed income generally failed to provide an effective counterbalance to equity risk. With that in mind, some investors have gravitated to public REITs. However, with higher inflation, lower expected returns, and heightened volatility, today's market environment requires a different toolbox.

REITs may offer an income-focused alternative to traditional stock-and-bond allocations, but we would argue that the real opportunities within real estate may lie in private real estate. Private real estate provides growth and income, diversification relative to traditional investments, and a potential hedge against the impact of inflation.

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ENDNOTES

1. "Global Family Office Report 2022," UBS, https://www.ubs.com/global/en/family-office-institutional-wealth/reports/gfo-client-report.html.
2. Prequin, CAIA Associates, as of December 31, 2021.
3. Clarion Partners Investment Research, as of September 30, 2022.
4. Clarion Partners Investment Research, as of September 30, 2022.
5. Clarion Partners Investment Research, as of September 30, 2022.

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