PERSPECTIVES

CRE in the face of uncertainty: Oasis or mirage?

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When volatility picks up, as it's doing now, investors look for ways to protect their portfolios.

Over the years, many have sought shelter in hard assets for inflation protection, stability and, in the case of commercial real estate (CRE), the ability to generate income. With stock market volatility expected to continue and low rates still plaguing fixed income investors, increasing allocations to CRE may be a smart move.

Caught in an informational sandstorm

Investors face a range of challenges today—falling yields, increasing volatility, global trade uncertainty (beyond just the U.S. and China)—along with plenty of daily distractions (remember cryptocurrencies?). Yet despite significant macro uncertainties, many fundamental economic drivers in the U.S. appear to be relatively sound—unemployment's low, economic growth is slow but positive, and a newly dovish Fed is attempting to keep the expansion going as long as possible.

The informational sandstorm in traditional markets can easily cloud investors' perspective on the best way to achieve their goals. Some might be considering allocating more to commercial real estate given its solid reputation for providing income and stability. But they also may be wondering if it is the right time for a shift—given that we're late in the cycle. At over 10 years, the current bull market for real estate has had a long run. Simply put, is CRE still an oasis or is its perceived safety a mirage?

Finding an oasis

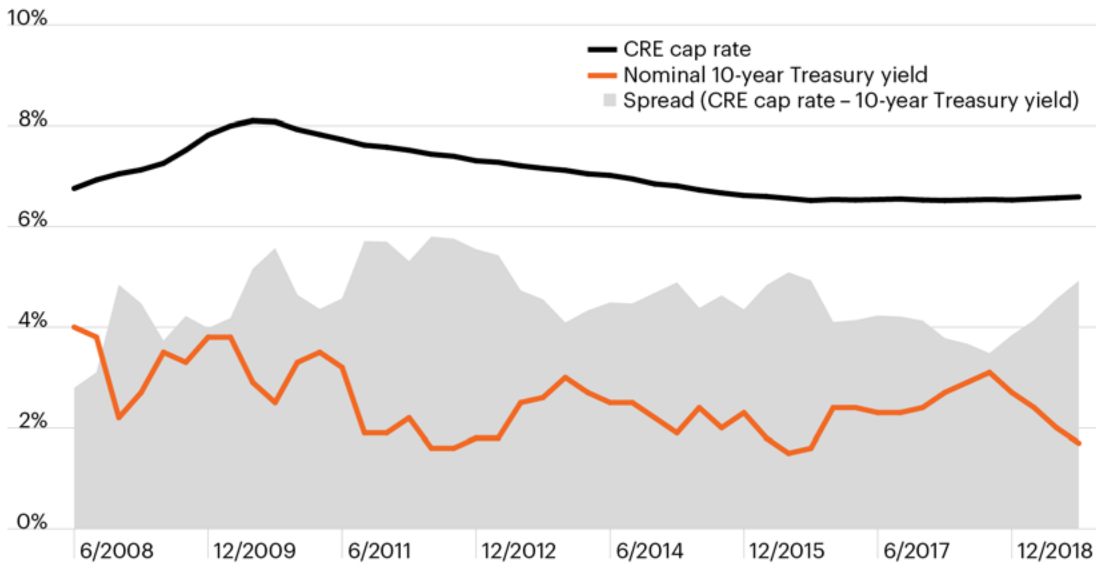
Looking past the traditional markets, the commercial real estate landscape appears inviting as fundamentals remain sound.

Earnings expectations are increasing. Earnings expectations for public real estate investment vehicles (REITs) are increasing while outlooks in traditional equity are deteriorating. Expected 2019 earnings growth for the S&P 500 declined from 7.9% to 3.5%. Growth expectations for REIT funds from operations increased from 3.1% to 3.3%. Given this backdrop, it's not surprising that public REITs have been trading at a premium to their net asset value in 2019 after over two years of trading at a discount.[1]

Valuations multiples are stable. Underlying real estate valuations have remained in check, with **capitalization rates** (the real estate equivalent of an inverse P/E ratio) hovering in the mid-6% range the last three years. As a result, price growth in real estate has come from increases in earnings (or net operating income) that are driven by solid underlying fundamentals.

Financing remains efficient and leverage levels are reasonable. While low interest rates have made debt financing attractive throughout this cycle, current leverage is well below levels seen before the financial crisis. The recent reduction in the federal funds rate should only serve to make real estate more enticing given the associated widening of the cap rate/10-year U.S. Treasury spread and cheaper financing for CRE equity investors.

CRE CAP RATE SPREADS WIDEN AS TREASURY YIELDS DECLINE



Source: Real Capital Analytics, Federal Reserve, as of September 30, 2019.

Overall, throughout the current cycle, CRE has exhibited an attractive risk-return profile, with less volatility than equities and low correlation to traditional markets. Given these benefits combined with strong fundamentals, how can investors find the best way to access CRE?

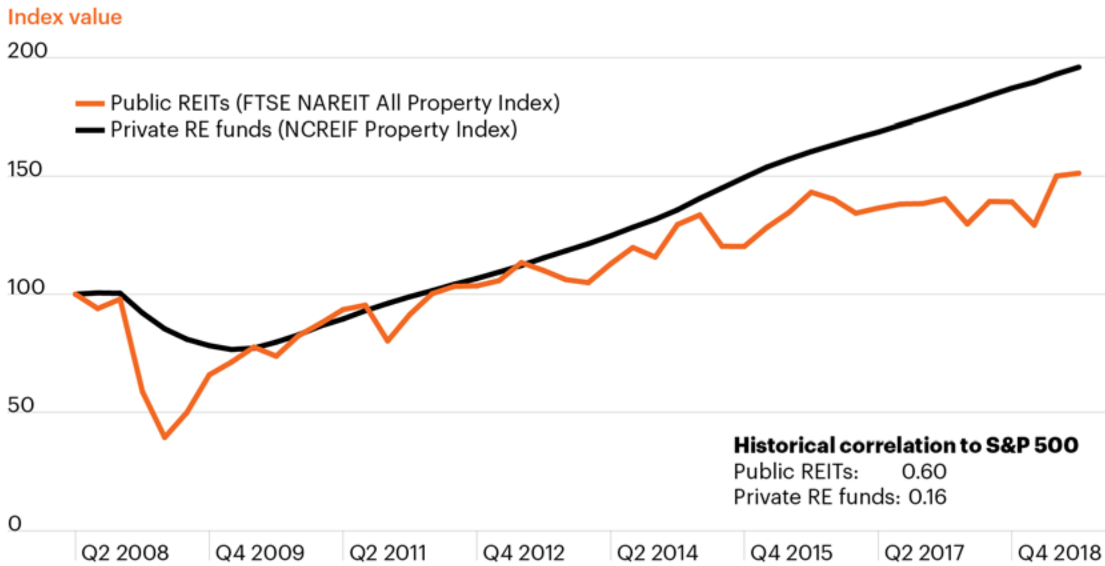
A road map through the desert

How one invests in CRE plays an important role in their investment experience. A key decision point for investors looking to access commercial real estate is whether to use a public structure—potentially offering more liquidity at the cost of additional volatility—or a private structure—potentially offering more stability at the cost of some liquidity. Let's compare.

1 J.P. Morgan.

Public markets – Public REITs have historically traded with a 0.60 correlation to the S&P 500 and tend to experience greater volatility. As a result, investing through the public markets generally provides a bit more of a wild ride. Public REITs may be priced at discounts or premiums to the underlying value of the real estate, so investment timing may significantly impact returns. On the other hand, one advantage of investing in the public market may be greater liquidity (REIT shares are bought and sold daily). Unfortunately, investors' return streams may deviate from underlying real estate asset prices/fundamentals over certain periods of time. Even if these dislocations correct, the timing may not align with investor needs.

PUBLIC VS. PRIVATE REAL ESTATE RETURNS



Source: Bloomberg Finance, L.P., as of October 9, 2019.

Private markets – Historically, private real estate has traded with just a 0.16 correlation to the S&P 500, with just a third of the volatility of public REITs. Accessing real estate through the private markets, or funds that price their shares based on NAV, may provide investors with less volatile returns that more closely resemble the experience of a direct investment in real estate. The trade-off is that investing "privately" often requires investors to give up some **liquidity** compared to the public markets. Not surprisingly, private real estate has exhibited lower volatility and correlation with broader markets.

Not a mirage

Driven by solid underlying macroeconomic fundamentals, the CRE market still has room to run despite this bull market lasting over 10 years. Bolstered by lower interest rates and demand for income and stability, the CRE oasis should provide a respite to investors feeling the heat in traditional markets.

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Matt is Managing Director of Real Estate at FS Investments, where he focuses on the growth and management of our real estate platform. His experience as a securities lawyer and Head of Due Diligence informs his unique perspective on the industry. Matt serves as Chair of the Board of Directors of the CFA Society of Washington, DC, and on the Board of Directors of ADISA.

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