Why U.S. Commercial Real Estate

The CoStar Portfolio Strategy Team
Introduction

The Investment Backdrop In 2018

Investor sentiment remains cautiously optimistic in 2018, and for good reason. The U.S. economy remains stable, with GDP growth of 2.3% in 2017 and consensus projections are for growth to accelerate in 2018 as the U.S. economy continues its slow-burn recovery. Healthy corporate earnings and newly enacted tax reform have boosted business investment while consumer spending remains stalwart. Recent readings of the ISM Manufacturing and Non-Manufacturing surveys are at cyclical highs, indicating the acceleration of economic growth could continue. Adding to the optimism, the U.S. is in the longest uninterrupted streak of monthly job growth on record and the Dow hovers near record highs.

While current conditions are undoubtedly positive, there are also reasons for caution. Investors are well aware that the U.S.’s aging economic recovery is entering its ninth year, making it the second-longest expansion in the post-war period. Also, the Federal Reserve has begun a program of monetary tightening. With long-standing policies on trade, defense and immigration being called into question in the Americas, Europe and Asia, global measures of political risk and economic policy uncertainty are near multi-decade highs.

The mixture of healthy near-term economic prospects and concerns over a slowdown poses challenges for many traditional asset classes. Bonds will come under pressure if economic growth improves further and inflation accelerates. Stock prices look increasingly vulnerable to sharp downside risk in the face of rapidly changing geopolitics and an aging economic expansion. Investments made in 2018 and beyond need to be nimble and capable of benefiting from a continuation in economic growth and modest inflation, while durable enough to ride out potential downside volatility. A diversified U.S. commercial real estate (CRE) portfolio meets these criteria.
Exhibit 1: Cumulative Returns On Investments Made Three Years Prior To A Recession (Average Performance From Past Four U.S. Economic Cycles)

Exhibit 1 shows the average performance during the past four economic cycles of investments made, starting three years prior to each of the past four recessions. Ultimately, commercial real estate produced the highest returns, with significantly lower volatility than stocks along the way. Rising rents and occupancy rates allow CRE to benefit in late-cycle periods of accelerating inflation, while consistent income generated by properties helps CRE hold up relatively well when the economy falls on hard times. This paper unpacks CRE’s historical performance and explains why the asset class makes a valuable contribution to a diversified investment portfolio in 2018 and beyond.

Sources: Barclays, Bloomberg, NCREIF, CoStar Portfolio Strategy
Notes: Returns are unleveraged.

As of 18Q1
Why U.S. Commercial Real Estate?

CRE Provides Exposure To The Outperforming U.S. Economy

CRE offers investors direct exposure to the outperforming U.S. economy. From 2014−17, foreign direct investments in the U.S. increased by $1.3 trillion. This marked the largest and most rapid influx of foreign investment into the U.S. since the BEA began compiling the data. CRE investment has been no exception, as 2015-17 had, by far, the highest dollar volume of foreign acquisitions of U.S. CRE on record. With China’s recent GDP growth being the slowest in 25 years, uncertainty surrounding the cohesion and economic competitiveness of the Eurozone, and near-stagnant growth in Japan, global investors continue to favor the U.S. The United States’ flexible labor laws, highly educated labor force, defense infrastructure, and intellectual property protection are all compelling factors attracting investment. Meanwhile, consensus expectations for U.S. GDP growth remain elevated above those for nearly every other developed economy (see Exhibit 2).

Exhibit 2: Consensus Average Annual GDP Growth Forecast (2018−19)

Sources: Bloomberg, CoStar Portfolio Strategy As of June 2018
The U.S.’s economic prospects are also bolstered by a demographic outlook superior to that of China, Japan and Western Europe (see Exhibit 3). Due to its significantly younger population, the U.S. still stands to surpass other major world powers in working-age population growth over the next 10 to 20 years, even with a potential slowdown in immigration. This gives the U.S. a structural advantage in achieving stronger long-term growth, regardless of possible short-term fluctuations in the economic cycle along the way.

Exhibit 3: Working-Age Population Index (2015=100)

While about one-third of the revenue generated by the S&P 500 comes from outside the U.S., CRE provides a direct avenue to acquire assets with exposure to the U.S. economy. The U.S.’s forecast GDP growth contributes to consumer spending at retail properties, goods stored in logistics properties and profits earned by office-using firms. Meanwhile, growth in the U.S. working-age population drives household formation and demand for apartments while increasing the pool of workers who need office space.
CRE Offers Income-Driven Returns

Commercial real estate has historically performed well compared to other investment alternatives from an absolute return perspective. But one of real estate’s most attractive features is that like the returns of bonds, CRE returns are heavily weighted to income over capital gains. As Exhibit 4 indicates, CRE has not produced the highest returns over time—stocks win that score. However, annual dividend payments from stocks have averaged only about 2.6% annually since 1980, meaning stocks generally produce meager returns until they are sold. Conversely, CRE has offered average annual income returns of 7.2% since 1980, as rent payments from tenants put returns in investors’ pockets more steadily during the hold period.

Exhibit 4: Average Annual Returns Since 1980

<table>
<thead>
<tr>
<th>Total Return (%)</th>
<th>Stocks</th>
<th>CRE</th>
<th>Bonds</th>
<th>Cash</th>
</tr>
</thead>
<tbody>
<tr>
<td>11.4%</td>
<td>8.7%</td>
<td>7.2%</td>
<td>4.1%</td>
<td></td>
</tr>
</tbody>
</table>

Sources: Barclays, NCREIF, Federal Reserve, CoStar Portfolio Strategy  
As of 18Q1

¹Throughout this paper, unless otherwise stated, CRE returns are derived from the NCREIF NPI Index, an unlevered index of institutionally owned U.S. private equity real estate; stocks returns are derived from the S&P 500 Index; bond returns are derived from the Barclays Capital U.S. Aggregate Index; and cash returns are derived from three-month Treasury Bill Rates.
The income advantage of CRE remains a driving force of investment flows into U.S. real estate in 2018, as U.S. CRE continues to offer relatively high income returns compared to interest rates on most-fixed income assets. In recent years, central bank bond purchases and strong investor demand for low-volatility assets have driven bond yields to record lows in most of the world’s major developed markets. The recent near-zero interest rates on some German and Japanese bonds best exemplify the challenges facing low-risk investors. Investors seeking assets generating reliable income returns face a choice: Buy bonds offering near-record-low yields, often barely above the rate of inflation, or consider other asset classes. U.S. CRE offers an attractive alternative.

Exhibit 5: CRE Offering Higher Income Returns In Yield-Starved Environment

In recent years, with central banks and investors more focused on buying bonds than CRE, yields offered by U.S. CRE (best represented by cap rates) have not compressed as rapidly as interest rates offered in the bond market. As Exhibit 5 shows, current cap rates offered by CRE rank well above income returns of a broad range of investment alternatives. CRE income returns also rise over long-term investment horizons with increasing rental rates, whereas interest income from most bond investments remains fixed and erodes in real value over time with inflation. Inflation expectations have increased in the U.S. recently with the labor market tightening and the fiscal stimulus delivery by the new administration. As a result, the ability of CRE income to rise over time could prove to be its crucial advantage over most fixed-income investments over the next five to 10 years.
CRE Adds Portfolio Diversity And Reduces Risk

The substantial contribution of steady income to CRE returns helps temper the volatility of the asset class. Even during economic recessions, the vast majority of commercial properties continue generating more income than operating expenses. This is not to say that CRE is immune to negative returns. During 1991–93 and 2008–09, real estate fell painfully into the red. But during other periods of economic stress, such as 1980–82 and 2001–03, real estate returns remained firmly positive, and their presence in portfolios helped dampen the effect of gut-wrenching losses in stocks. As Exhibit 6 indicates, over the long term, average annual returns in CRE have only trailed those in stocks by about 270 basis points, whereas CRE volatility in returns has been almost 1,000 basis points below returns volatility in the stock market. Moreover, CRE’s return-to-volatility ratio remains relatively high compared to that of other major asset classes.

Exhibit 6: Returns & Volatility Across Asset Classes

<table>
<thead>
<tr>
<th></th>
<th>Average Annual Returns In Returns Since 1980</th>
<th>Standard Deviation of Total Returns</th>
<th>Return/Risk Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>CRE</td>
<td>8.7%</td>
<td>7.4%</td>
<td></td>
</tr>
<tr>
<td>Bonds</td>
<td>7.2%</td>
<td>7.1%</td>
<td></td>
</tr>
<tr>
<td>Stocks</td>
<td>11.4%</td>
<td></td>
<td>1.74%</td>
</tr>
<tr>
<td>REITs</td>
<td>10.8%</td>
<td></td>
<td>1.96%</td>
</tr>
</tbody>
</table>

Sources: Barclays; NAREIT; NCREIF; CoStar Portfolio Strategy

As of 18Q1
The sheer size of the U.S. CRE market also bolsters the case for its inclusion in a well-diversified investment portfolio. As shown in Exhibit 7, the market capitalization of U.S. CRE measures nearly $15 trillion (or more than $20 trillion if specialty property types such as healthcare and stadiums/sports facilities are included). While CRE’s U.S. market capitalization remains well below that of publicly traded U.S. equities, it is comparable in size to the U.S. corporate bond market, and much larger than other asset classes commonly bought and sold by institutional investors, such as muni bonds and private equity. Given CRE’s favorable risk return profile historically and its significant share of the overall investable universe, this implies that investors should not be asking, “Why U.S. real estate?” but rather, “Why not real estate?” and “How much?”

Exhibit 7: U.S. Market Capitalization By Asset Class

Sources: Federal Reserve, Prequin, CoStar Portfolio Strategy
*Includes multifamily, office, industrial, flex, retail, and hotel properties.
**Private Equity refers to institutionally managed global private equity AUM

As of 18Q1
A mainstay of modern portfolio theory is that when separate assets perform differently from one another over time, investors can earn greater return at each level of risk by combining the different assets into a single portfolio. CRE has produced long-term returns that are competitive with other major asset classes, but its variable income stream (a feature relatively unique to real estate) helps CRE to perform differently than other major asset classes throughout the economic cycle and to maintain a low correlation with stocks and bonds (see Exhibit 8).

**Exhibit 8: Correlation Of Asset Class Returns (1980–18Q1)**

<table>
<thead>
<tr>
<th></th>
<th>CRE</th>
<th>Stocks</th>
<th>Bonds</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>CRE</strong></td>
<td>1</td>
<td>0.17</td>
<td>-0.15</td>
</tr>
<tr>
<td><strong>Stocks</strong></td>
<td>0.17</td>
<td>1</td>
<td>0.22</td>
</tr>
<tr>
<td><strong>Bonds</strong></td>
<td>-0.15</td>
<td>0.22</td>
<td>1</td>
</tr>
</tbody>
</table>

Sources: Bloomberg, Barclays, CoStar Portfolio Strategy

Using modern portfolio theory, it is possible to construct portfolios with optimal allocations of various asset classes—given the historical risk and return profiles of each asset class and their correlations—to minimize the portfolio volatility for any given level of target return. These optimal portfolio allocation combinations, which do not take into account investors’ liquidity preferences, at each level of target return, make up what is known as the efficient frontier. Exhibit 9 indicates that significant allocations to CRE have historically been necessary to allow most investment portfolios to minimize volatility in returns. The only portfolios that benefited from minimal exposure to CRE (allocations below 15%) were those that sought returns either at extreme lows or extreme highs of the spectrum.
Conclusion

The long-term benefits of U.S. commercial real estate investment have been proven again and again over the past 30 years. The asset class’s significant size within the investable universe, robust income-driven returns, lower volatility, and low correlations with other major asset classes all support commercial real estate’s inclusion in a well-diversified investment portfolio. The case for U.S. CRE is further bolstered considering the economic and capital markets backdrop in 2018. The asset class offers investors direct exposure to the outperforming U.S. economy, which has a superior long-term demographic outlook compared to that of other major world economies. Furthermore, CRE investments have historically outshined stocks and bonds during mature stages of the economic cycle. This outperformance has been supported by CRE’s robust income streams, which often rise along with inflation and serve to dampen commercial real estate’s volatility during periods of economic stress.
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