Portfolio Diversification with Real Estate

Marwan Favre
Analyst

Real estate offers investors long-term stable income, protection from inflation, and diversification benefits due to its low correlation with other asset classes. Find out different options to benefit from exposure to real estate depending on your investment strategy.

Types of Real Estate Investments

Real Estate Equity Investments

For this type, an equity investor has an ownership interest, such that the investor is either the sole or a joint owner of a property or an investment vehicle that owns the real estate asset.

Equity investors in real estate derive their returns from two main sources:

Current income - Investors may expect to earn current income on the property through leasing or renting the property. A typical example is leasing out a high-quality multi-family real estate complex.

Capital Appreciation - Due to the increasing demand for housing on the back of demographic changes, real estate assets often witness appreciation in prices allowing investors to exit their equity stakes at higher prices to achieve capital gains. A ground-up development of an industrial complex then selling it afterwards falls as an example of this strategy.

Investing in real estate can either be through public or private markets. Private equity investment is done through a private equity vehicle, such as commingled funds where private capital is raised to obtain interest in real estate assets. In the case of public equity real estate, the financing of real estate is done through public markets via a vehicle called Real Estate Investment Trusts (REITs), which are companies that own or finance income-producing real estate across a range of property sectors and are mostly traded on major stock exchanges.

Real Estate Debt Investments

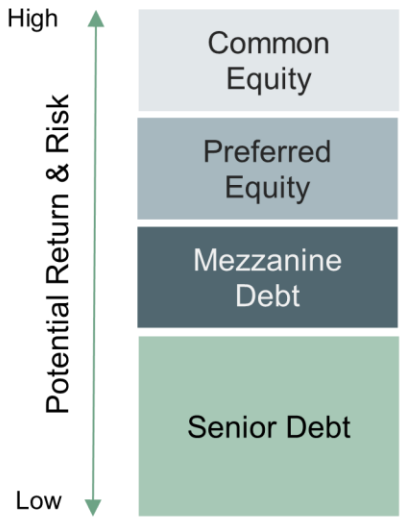
Private lending has been growing ever since the Global Financial Crisis of 2008, particularly after the introduction of Basel III that aimed at reducing the level of risk in the banking system. Due to Basel III, banks became less interested in lending to smaller companies as it requires them to hold more capital. This has created a lending gap that private lenders filled.

In the context of real estate, most private markets go after loans that banks will generally not finance as they have strict criteria for real estate lending related to the income and pre-sales of the project. Private lenders often lend based on the value of the asset and can charge a higher interest rate.

Private lending/debt now fills a significant part of a general asset allocation, sitting between fixed income and alternative assets. As interest rates have continued to fall over the past 10 years, investors have increasingly looked for other ways to generate consistent income returns and have looked to private lending, leading to growth in funding providers.

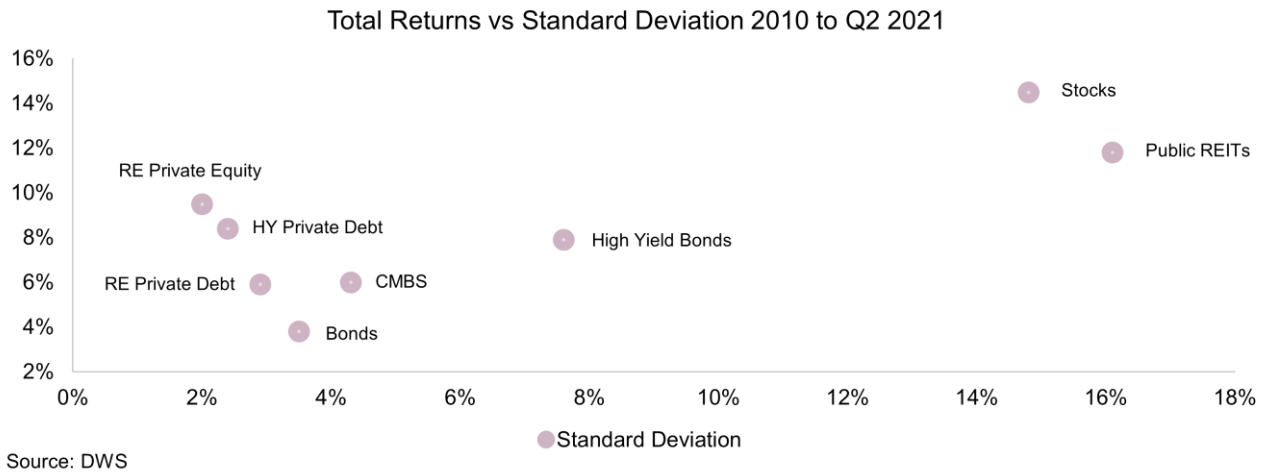
Real Estate Equity vs Real Estate Debt

When compared to debt, equity comes with a higher risk level as debt investors get paid before equity investors. Consequently, equity investors demand a higher return to compensate for their lower capital priority. In addition, equity investors receive the highest benefit of capital appreciation in a property.



By contrast, debt is relatively more secure when compared to equity. It is often collateralized by the property/real estate asset which provides a degree of recourse for the lender. As the amount of debt (financial leverage) on a property increases, risk increases for both debt and equity.

Both real estate equity and debt investments offer solid returns and their lower volatility boosts their performance on a risk-adjusted basis.



Source: DWS

Due Diligence by Real Estate Investing

- Physical Due Diligence: It starts with examining the overall region, the neighborhood, and down to the physical condition of the asset itself. It is crucial to understand the dynamics of the area (population size, job growth, household income levels, property value trends, social factors, etc.), as well as the condition of the property. These factors will affect the value of the asset and the leases/rents.

- Financial Due Diligence: Projections of revenues and expenses (development, maintenance, general property services, etc.) based on the region are paramount to value the business and to discuss financing options for the purchase.

Correlation Table 2001-2021

	RE Private Debt	RE Private Equity	CMBS	Public REITs	Bonds	Stocks	10-Year Treasury
RE Private Debt	1.00						
RE Private Equity	-0.03	1.00					
CMBS	0.83	-0.03	1.00				
Public REITS	0.42	0.29	0.69	1.00			
Bonds	0.67	-0.24	0.47	0.01	1.00		
Stocks	-0.02	0.21	0.34	0.66	-0.39	1.00	
10-Year Treasury	-0.19	-0.02	0.02	0.29	-0.67	0.56	1.00

Source: DWS (Correlation are calculated on a quarterly basis)

Diversification within Real Estate

Role of Real Estate in a Portfolio

Real estate has long been seen as an attractive source of investment returns by both individual and institutional investors. When introduced to a multi-asset portfolio, real estate plays a key role when it comes to diversification due to its low correlation with other asset classes, thereby enhancing the portfolio's risk-adjusted returns.

Geographical Location

Real estate assets are typically priced on a local basis; their performance relies on the local supply-and-demand factors and local regulations. Even if within the same country, different regions will have varying drivers. This highlights the need to diversify among geographies to reduce risks through the different market cycles in each region, and hedge against a major correction in one market. It is important to look for markets with favorable demographic changes, high job growth, and job diversity. This will increase the probability that such markets could witness strong growth in the coming years.

Property Type

The variety of asset types is one of the things that make real estate investing such a unique opportunity - from single-family homes to multifamily, from retail complexes to self-storage, and more. Investing in different types of properties can hedge against negative macroeconomic changes.

Different real estate assets have distinct dynamics:

- Residential Properties: This includes single-family detached houses and multi-family properties. Leases are usually short which offers a good hedge against inflation.

- Industrial and Warehouse Properties: Examples include assets for manufacturing or storage; they often have a longer lease duration than residential real estate.

Core	Core+	Value Add	Opportunistic
Sound and stable assets in prime metropolitan locations and established markets	High quality assets with minor upgrade needs	Assets that need repositioning or redevelopment to maximize the value	Distressed properties and loans, ground-up (re-) development
90% income / 10% appreciation Leverage:15% to 30% Hold: 10+ years Development: Minimal	80% income / 20% appreciation Leverage: 30% to 50% Hold: 7+ years Development: Minimal	40% income / 60% appreciation Leverage: 40% to 70% Hold: 3-5 years Development: Moderate	40% income / 60% appreciation Leverage: 40% to 70% Hold: 3-5 years Development: Moderate/High

- Office Properties: Demand for office space was often dictated by employment growth pre-pandemic, which has drastically changed due to the growing trend of working from home or hybrid setup.

- Retail Properties: These commercial properties used for marketing and selling goods/services usually have long leases that provide a level of cash flow stability.

- Hospitality Properties: Hotels/motels, luxury resorts, and event centers are among the prominent examples whose cash flows increase quickly in times of high demand, but are susceptible to market downturns.

Investment Type

Real estate investments, whether equity or debt, are classified across the risk spectrum of strategy types with varying return and risk drivers:

Key Takeaways

- There are different options to invest in real estate asset class depending on the investor's goals and strategy.

- Diversifying a real estate portfolio across geographies and property types helps to reduce the potential impact of risks, such as natural disasters, regulatory and political, and those associated with a particular property.

Petiole grew its expertise in private real estate through many cycles of investing in this asset class. We maintain a disciplined approach in deal selection, risk management, and portfolio construction. Contact our team to know our real estate strategy in key regions.

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Marwan Favre works as an investment analyst supporting Petiole Asset Management AG through its sister company, The Family Office Co. He holds a master's degree in investment management from Cass Business School.

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