DURABILITY OF **COMMERCIAL REAL ESTATE**

BY **JOHN EMRICH**

We believe commercial real estate (CRE) has proven to be a durable asset class over the last 50 years. A 2021 research summary based on historical market performance data since 1972[1] concluded that, when compared to U.S. small company (small-cap) stocks, large company (large-cap) stocks, long-term government bonds, and Treasury bills, the NAREIT All Equity Real Estate Investment Trusts (equity REITs) total return series[2] outperformed all other public asset classes except the index of small-cap stocks.[3] While the summary concluded that equity REIT prices have been as volatile as the stock market generally over this time period, the income produced by REITs has been "relatively stable."[4] We believe this implies that investments in commercial real estate have the potential to provide investors with positive relative and absolute long-term returns even when the rest of a diversified portfolio of stocks and bonds is struggling, thereby reducing downside volatility and portfolio stress.

The equity REITs described above invest in all sectors of CRE, including multifamily, retail, industrial, hotels, and special purpose properties. This first of four articles from Bespoke Holdings Company (BHC) on the nature of real estate risk and returns explores five reasons why we believe the durability in CRE exists, and why BHC focuses on the industrial subsector specifically.

LONG-TERM LEASES

Commercial real estate is typically leased to tenants for multi-year periods, providing a stable and predictable stream of income for the property owner. The industrial subsector is no different. Within a portfolio of properties, lease renewals can be staggered over different calendar years, further enhancing stability. Lease payments are not a discretionary expense for industrial real estate tenants. Companies may have options to cut certain costs in tough times; the rent on the building where the business operates is not among them. To this end, in 2019, the Financial Accounting Standards Board (FASB) began requiring publicly traded companies to capitalize long-term operating leases on their balance sheets to prevent companies from hiding what FASB saw as a liability equivalent to a debt obligation.[5]

We believe that the stable income streams found in CRE lend credence to the idea that, on the continuum of risk between stocks and bonds, industrial real estate skews towards fixed income compared to other equity alternatives, such as a stock market index, and may result in higher risk-adjusted returns when compared to those alternatives. This is not to suggest that CRE is immune to the risk of a black swan (i.e., an event with no historical precedent and catastrophic consequences). Investors in the office subsector experienced just such a shock due to the COVID pandemic and the subsequent "work from home" revolution.6 In sum, not all real estate is created equally.

DIVERSIFICATION

An allocation to an asset class with the attributes of industrial real estate can mitigate some portfolio risk without sacrificing long-term total return, whether you define risk as price volatility, permanent capital loss, or failing to achieve return objectives. A dirty little secret about the academic theory behind the advertised benefits of diversification is that those benefits can disappear when you need them most: periods of market and economic stress. Such was the case during the 2007-2008 Great Financial Crisis and the recession that followed.7 Knowing you own hard assets generating steady cashflow can mitigate some of the real and imagined pain caused by such economic contractions.

This is where a distinction between price movements in publicly traded assets and volatility in fundamental business results is important. Correlation measures how assets move in price together. A correlation of "1" implies that two assets are perfectly correlated; their prices will move up and down in lock step. The closer to 1 the correlation gets, the less the potential diversification benefit. For example, the 2021 research summary referred to above found the correlation between large-cap stocks and small-cap stocks is a relatively high .72.8 Conversely, the summary found that publicly traded equity REITs have shown a correlation of .54 with large-cap stocks (and a near zero correlation with bonds), while generating a higher total return.9 We believe these statements suggest that an investment portfolio currently comprised of just stocks and bonds could benefit in the form of higher total return and lower volatility by adding exposure to real estate. We will leave the "mark-to-market versus market-to-model" discussion for a future article. A discussion about tangible assets generally is appropriate now.

TANGIBLE ASSET

CRE is a tangible asset that can be seen, felt, and utilized, more so than branding, research and development, and software, or for that matter securities such as stocks and bonds. The land underneath (or adjacent to) our industrial real estate buildings possesses its own scarcity value and can generate its own income. The tangible nature of both the land and the building provides another appealing attribute of commercial property: protection against the ordinarily destructive nature of inflation.

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INFLATION HEDGE

We hesitate to describe real estate investments as a "hedge" because hedges are often used to decrease volatility but often at the expense of long-term return. Instead, it is the inherent nature of an income-generating hard asset to absorb and pass along price increases which can give rise to inflation. Long-term leases cause a lag in the reaction of rents to general inflation, but the benefits to income do eventually surface. Moreover, with one real estate appraisal methodology being replacement cost, higher prices in the commodities necessary to replicate a building also influence the market value of an existing property. Lastly, as construction is a labor-intensive process, a building's replacement cost and market value have the potential to correlate positively with rising wages.

Our statements above are not intended to suggest that private real estate investing is a model that guarantees superior risk-adjusted returns merely by allocating to the asset class. BHC is an active manager, allocating to a select group of assets, any one of which could have unanticipated property-specific problems while the entire portfolio can be influenced by the same swings in variables that impact real estate generally, public or private. We do, however, believe that the attributes of CRE described above have the potential to act as a "wind at the back" of long-term investors. The fifth factor can be either friend or foe for active real estate investors such as BHC.

LOCATION

The location of a commercial property is a key factor in whether the investment proves to be both stable and durable. The quality of a location is dependent on both the inventory of existing properties of similar size and functionality as well as the demographic characteristics of the local population. Too much supply of inventory relative to demand can swamp the inherent benefits of real estate investments. A local population that isn't growing can represent an insurmountable headwind to real rent growth. Conversely, a market with above-average population growth, supported by better than average housing affordability and quality of life, should continue to see benefits from population migration. If industrial rents in the high-growth markets are below average while supply is in line with past demand, those rents should eventually converge with rents in more expensive markets. Investors like BHC can do better still by drilling down to both submarkets within Metropolitan Statistical Areas (MSAs)10 and sub-asset classes within industrial real estate to optimize both growth and supply-demand metrics. The data is available. Investors ignore it at their peril.

CONCLUSION

For many reasons, including those stated above, we believe commercial real estate allocations can provide increased stability to investment portfolios. Long-term leases, lack of correlation to other asset classes, and a natural immunity to inflation all combine to create resilience. Forecastable scarcity value due to rapid population growth and a dearth of certain asset types provide not just downside protection but meaningful upside potential. Industrial real estate provides its own set of tail winds from onshoring, near shoring, a decade-long infrastructure spending program, and an historically high age of existing residential and commercial infrastructure.

Stay tuned for deeper dives into real estate returns, risk management, market (in)efficiency, and why we at Bespoke Holdings Company favor industrial real estate over other alternatives.

For more information on Bespoke Holdings Company, please contact: ***admin@bespokeholdingsco.com***

1 See Stocks, Bonds, Bills, and Inflation (SBBI) Summary Edition 2021 ["SBBI Summary"], available at https://www.cfainstitute.org/en/research/foundation/2021/sbbi-2021-summary-edition.

2 The FTSE Nareit All Equity REITs Index is a free-float adjusted, market capitalization-weighted index of U.S. equity REITs. Constituents of the index include all tax-qualified REITs with more than 50 percent of total assets in qualifying real estate assets other than mortgages secured by real property: https://www.reit.com/data-research/reit-indexes/real-time-index-returns/fner-ftx.

3 See SBBI Summary p. 34 for underlying indices and performance data relating to the asset classes referred to above.

4 See SBBI Summary pp. 34-35.

5 See Financial Accounting Standards Board, Leases, https://www.fasb.org/leases#section-1.

6 See https://www.greenstreetadvisors.com/insights/blog/the-work-from-home-revolution-implications-for-the-office-sector.

7 See https://en.wikipedia.org/wiki/2007%E2%80%932008_financial_crisis .

8 See SBBI Summary pp. 36-37.

9 See SBBI Summary pp. 34-38.

10 An MSA consists of one or more counties that contain a city of 50,000 or more inhabitants or contain a Census Bureau-defined urbanized area (UA) and have a total population of at least 100,000 (75,000 in New England). The general concept of a metropolitan area is that of a core area containing a large population nucleus, together with adjacent communities that have a high degree of economic and social integration with that core: https://www2.census.gov/geo/pdfs/reference/GARM/Ch13GARM.pdf.