Institute

Private real estate: Unlocking opportunities beyond stocks and bonds

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Key points

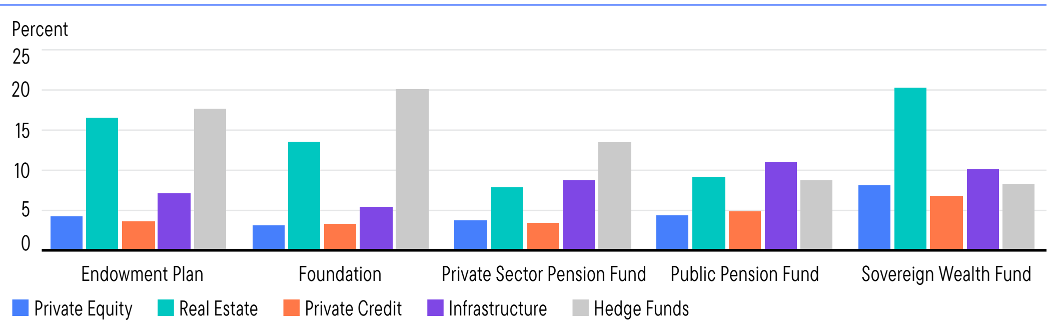
- Private real estate is a significant portfolio allocation for family offices and institutional investors
- The asset class has historically delivered attractive risk-adjusted returns, an inflation-resistant income stream, and portfolio diversification—outcomes that resonate in today's market environment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

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. According to the UBS Global Family Office survey,[1] the average allocation to real estate was 13%. Among institutional investors, the allocations range by institutional segment, and the size of the institution.

How Institutions Allocate to Alternatives

Exhibit 1: Alternative Diversification Amongst Institutional Investors

As of February 5, 2023



Sources: Preqin, CAIA Association (2023)

With this level of allocation, it's not surprising that real estate represents the 3rd largest asset class in the U.S., with nearly $11.2 trillion in AUM, after fixed income and equities.[2] The vast majority (90%) of that $11.2 trillion AUM is accounted for by private real estate, i.e., properties owned by private investors—primarily commercial real estate, from distribution centers to multifamily dwellings to office complexes.

Multiple avenues of potential return

This multifaceted asset class features diverse opportunities across a wide range of commercial property sectors and regions which may behave differently in response to macro conditions—creating potential opportunities for actively managed real estate investors.

COVID impacted commercial real estate in multiple ways. The industrial sector benefited from the rapid expansion of e-commerce during the pandemic lockdowns, thanks to increased demand for large-scale fulfillment centers near major metros. We have also seen growing demand for facilities due to onshoring and moving our supply-chains closer to home. In contrast, the office sector was notably 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, while demand for multifamily housing tends to be more influenced by trends in population and social trends. Indeed, the multifamily sector has benefited greatly from increased household formation in the wake of the COVID lockdowns and the affordability challenges across all residential housing. Similarly, purpose-built life sciences properties have seen solid demand thanks to an aging U.S. population, rising healthcare spending and employment, and a rapid rise in R&D funding.[3]

Recognizing Differences Between Property Types

Exhibit 2: Key Considerations for Investors

		Key Considerations
Multifamily	Residential buildings with multiple housing units	• High-rise, mid-rise or garden-style • Quality level varies based on condition, location and amenities
Office	Office work environments	• Tenant capacity • Related amenities • Quality level varies based on location, proximity to transportation and construction types

Industrial	Properties dedicated to distribution, research storage and manufacturing	• Business type
		  ◦ Life sciences
		  ◦ Warehouses
		  ◦ R&D facilities
		  ◦ Manufacturing
		  ◦ Flex (industrial/office)

Retail	Properties dedicated to the sale of goods and services	• Single-tenant or multi-tenant
		• Business type
		  ◦ Shops
		  ◦ Restaurants
		  ◦ Banks
		  ◦ Gyms

For illustrative purposes only.

These differences help explain why the total return for various property types can vary significantly from year to year, as shown below. As the data illustrates, industrial warehouses have generated strong and consistent results over the last several years, while the office sector has struggled due to the work-from-home movement and the migration of workers from big cities. We believe that these secular trends will continue.

Real Estate Is a Cyclical Sector

Exhibit 3: Real Estate Sector Performance

As of December 31, 2023

2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Retail 12.89%	Industrial 13.42%	Retail 15.27%	Industrial 9.22%	Industrial 12.77%	Industrial 14.30%	Industrial 13.37%	Industrial 11.77%	Industrial 43.34%	Industrial 14.54%	Hotels 10.32%
Industrial 12.32%	Retail 13.12%	Industrial 14.39%	Retail 9.04%	All Property 7.06%	Hotels 7.57%	Offices 6.60%	Apartments 1.82%	Apartments 19.91%	Hotels 9.96%	Retail –0.90%
All Property 11.01%	All Property 11.97%	All Property 13.50%	All Property 8.00%	Offices 6.25%	Offices 6.85%	All Property 6.42%	All Property 1.61%	All Property 17.70%	Apartments 7.07%	Industrial –4.07%
Apartments 10.42%	Offices 11.91%	Hotels 13.22%	Apartments 7.32%	Apartments 6.17%	All Property 6.71%	Apartments 5.52%	Offices 1.57%	Offices 6.11%	All Property 5.52%	Apartments –7.33%
Offices 9.92%	Hotels 11.06%	Offices 12.92%	Offices 6.27%	Retail 5.67%	Apartments 6.07%	Hotels 3.51%	Retail –7.48%	Hotels 5.48%	Retail 2.70%	All Property –7.94%
Hotels 7.69%	Apartments 10.36%	Apartments 11.98%	Hotels 4.72%	Hotels 4.93%	Retail 2.18%	Retail 1.90%	Hotels –25.57%	Retail 4.23%	Offices –3.36%	Offices –17.63%

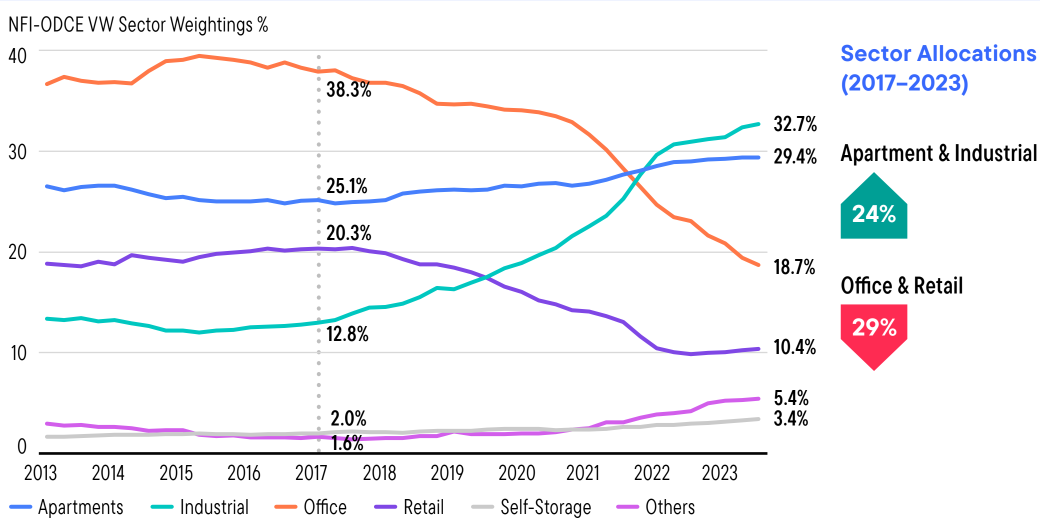
Sources: NCREIF, Macrobond. Indices Used: NCREIF National Property Index, NCREIF Office Property Index, NCREIF Apartment Property Index, NCREIF Industrial Property Index, NCREIF Retail Property Index, and NCREIF Hotel Property Index. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. **Past performance is not an indicator or a guarantee of future results.** Important data provider notices and terms available at www.franklintempletondatasources.com.

While the office sector has generated a lot of headlines in recent years, it has become a smaller percentage of the commercial real estate institutional allocation, shrinking from nearly 40% a few years ago, to approximately 19% today. Conversely, industrials and apartments have grown substantially over the same time period.

Office and Retail Sectors are Down, While Apartments and Industrials are Up

Exhibit 4: Private Real Estate Sector Allocation in Recent History

As of Q3 2023



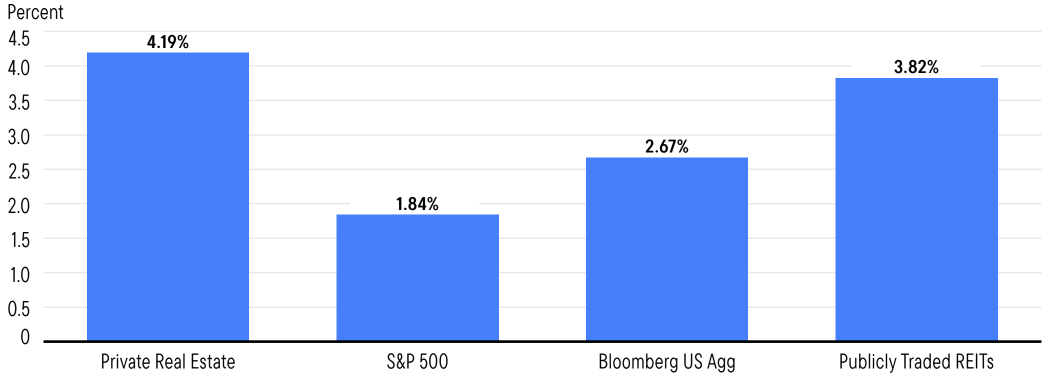
Sources: Clarion Partners Investment Research, NCREIF, 2023Q3. NFI-ODCE VW is NCREIF Fund Index—Open End Diversified Core Equity (NFI-ODCE) Value Weighted. The NFI-ODCE is a capitalization-weighted index based on each fund's net invested capital, which is defined as beginning market value net assets (BMV), adjusted for weighted cash flows (WCF) during the period. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. **Past performance is not an indicator or a guarantee of future results.** Important data provider notices and terms available at www.franklintempletondatasources.com.

Real estate has historically provided attractive income relative to traditional options.

Alternative Sources of Income

Exhibit 5: Annual Yields (10-Year Average)

As of December 31, 2023



Sources: NCREIF, FTSE, S&P 500, Bloomberg. Analysis by Franklin Templeton Institute. Private Real Estate: 10-year average income return for NCREIF ODCE as of 12/31/2023, S&P 500: S&P Dow Jones Indices 10-year average dividend yield as of 12/31/2023; Bloomberg US Agg 10-year average yield to maturity as of 12/31/2023; Publicly Traded REITs: 10-year average dividend yield for FTSE NAREIT All Equity REITS Index as of 12/31/2023. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. **Past performance is not an indicator or a guarantee of future results.** Important data provider notices and terms available at www.franklintempletondatasources.com.

Attractive investment fundamentals

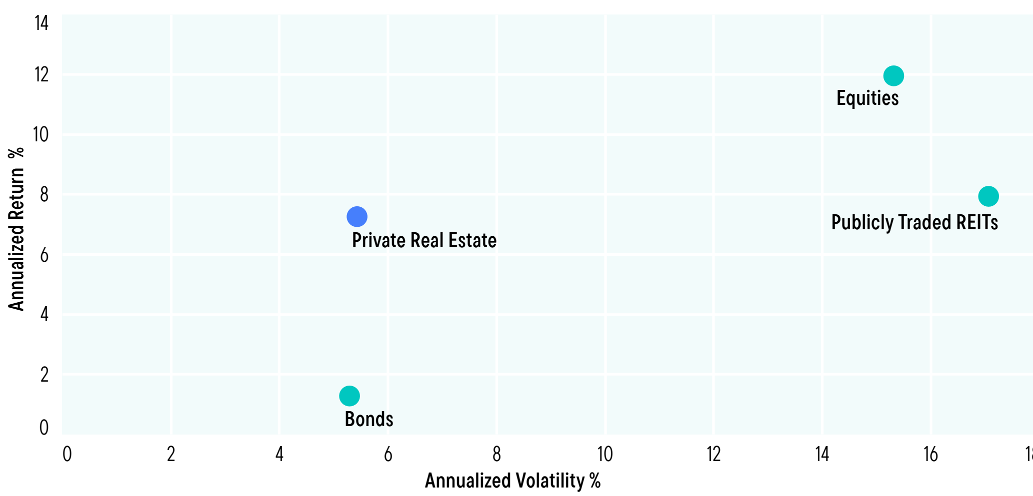
Private real estate is valued by institutions and high-net-worth investors in part because of what it may contribute to a portfolio: attractive income, solid risk-adjusted returns, and effective diversification relative to a traditional stock/bond portfolio.

For all property types, rent payments from leases represent the primary source 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 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.

Higher Historical Return than Bonds, with Less Volatility than Stocks

Exhibit 6: Annualized 10-Year Total Return and Volatility

As of December 31, 2023



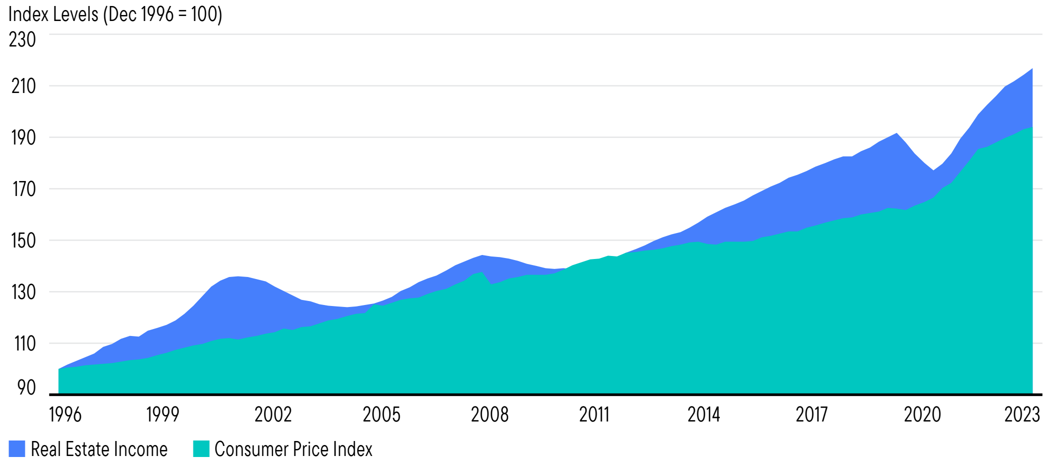
Sources: NCREIF, FTSE, S&P Dow Jones Indices, Bloomberg and Morningstar Direct. Analysis by Franklin Templeton Institute. Private Real Estate: NCREIF Fund ODCE Index, Equities: S&P 500 Total Return Index, Bonds: Bloomberg US Aggregate Bonds Total Return Index, Publicly Traded REITs: FTSE NAREIT All Equity REITs Index. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. **Past performance is not an indicator or a guarantee of future results.** Important data provider notices and terms available at www.franklintempletondatasources.com.

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 allow private real estate rents to outpace inflation over most recent cycles, as seen below.

Inflation-Resistant Income

Exhibit 7: Real Estate Income vs CPI Inflation

As of Q4 2023



Source: Clarion Partners Investment Research, NCREIF, BLS, Moody's Analytics.

Note: Real Estate Income Index is based on NPI Quarter-over-Quarter Same-Store NOI growth; Consumer Price Index is CPI All Items seasonally adjusted.

As an alternative asset class, real estate may also provide significant diversification benefits when added to a traditional portfolio. As shown below, private real estate has exhibited a 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. It is worth noting that publicly-traded REITs are more correlated to stocks than commercial real estate.

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

Why Invest in Private Markets

Exhibit 8: Correlation to Traditional Assets

10 Years Ending September 30, 2023

	Private Credit	Real Estate	Private Equity	Hedge Funds	REITs
US Equities	0.69	–0.23	0.79	0.92	0.69
US Bonds	–0.44	–0.29	–0.04	–0.12	0.17

Sources: Burgiss, S&P Dow Jones, NCREIF, Bloomberg, Cliffwater LCC, FTSE, HFRI, Macrobond, Morningstar Direct. Analysis by Franklin Templeton Institute. Indexes used: Private Credit: Cliffwater Direct Lending Index; Private Real Estate: NCREIF Fund ODCE, US Stocks: S&P 500 TR USD, US Bonds: Bloomberg US Agg Bond TR USD. Hedge Strategies – HFRI Fund Weighted Composite. U.S. Private Equity-Burgiss US Private Equity Funds Index. REITs: FTSE Nareit All Equity REITs TR USD. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. **Past performance is not an indicator or a guarantee of future results.** Important data provider notices and terms available at www.franklintempletondatasources.com.

Expanding access with enhanced liquidity

While many individual investors may have personal experience with real estate through home ownership, private real estate investing involves many more variables and can take several forms. Many individuals have some familiarity with publicly-traded REITs (Real Estate Investment Trusts), a specialized investment vehicle that make direct investments in commercial properties. REITs are required to distribute 90% of taxable income to shareholders, and are generally oriented toward income generation. They may be publicly traded, or privately held. Private REITs are registered with the SEC, 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. Rather than "flipping" properties for rapid gain, they generally build value over time and generate meaningful income for tenants. A high degree of illiquidity is inherent in the asset class; as a result, traditional private real estate funds impose major restrictions on the timing and scope of withdrawals, set large ($1mm+) investment minimums; and require investors to provide additional funding via capital calls as needed. In addition, participation is limited to qualified purchasers, i.e., individuals with $5mm or more in investment assets.

However, over the last decade, private real estate is gaining greater attention from advisors and their clients through the availability of registered funds, including interval and tender offer funds. 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.

An Expanded Range of Choices

Exhibit 9: 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.

*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.

Interval and tender offer funds generally have lower minimums, enhanced liquidity and greater transparency with their holdings. Some, but not all, may limit participation to accredited investors. Interval funds provide quarterly liquidity, and daily net asset valuations (NAV). 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

Commercial real estate has historically delivered strong risk-adjusted returns, attractive income, diversification, and inflation hedging. While the office sector has been struggling lately, industrials, multifamily housing and life sciences offer attractive opportunities. Commercial real estate should be viewed as a long-term investment. Product innovation like interval and tender-offer funds have made real estate more accessible, to a broader group of investors, at lower minimums, and greater flexibility.

Advisors can learn more about how to effectively incorporate these versatile and valuable tools at our **Knowledge Hub** on Alternatives by FT.

Contributors

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Endnotes

1. Source: 2023 Global Family Office Report, UBS.
2. Sources: Securities Industry and Financial Markets Association, Urban Land Institute, NAREIT, NCREIF and Clarion Partners Investment Research, December 31, 2021.
3. Source: Clarion Partners Investment Research, September 30, 2022.

Definitions

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.

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.

Business Development Corporation (BDCs) is a specialized type of closed- end investment company designed to raise capital for small and mid-size companies.

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.

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 their inception and issue shares to investors which can be traded on public exchanges. An interval fund is a type of closed-end fund which is not publicly traded and allows shareholders to withdraw some portion of their investment at regularly scheduled intervals. A tender-offer fund is similar, but with redemptions available only at the discretion of the board rather than being available on a pre-determined schedule.

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

Distribution rate expresses the income and capital distributed to investors as a percentage of the total investment capitalization.

Family offices are private financial advisors employed by very wealthy families or individuals to provide customized planning and investment management services tailored to their specific needs.

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.

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.

K-1 is a US tax return schedule used to report an investor's share of the profits and losses from a business partnership.

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

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

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

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

A REIT (Real Estate Investment Trust) is a specialized type of company designed to own and/or invest in real estate properties which required by law to distribute at least 90% 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.

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

Standard deviation is a statistical measure of the variation from the average (mean) in a set of data commonly used to assess the volatility of investment returns over a given time period.

Yield to worst (YTW) is the lowest potential yield that can be received on a bond without the issuer actually defaulting.

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An investment in a tender offer or interval fund is not suitable for all investors. Unlike closed-end funds, a tender offer or interval fund's shares are not typically listed on a stock exchange. There is also no secondary market for the fund's shares, and none is expected to develop. Even though a tender offer or interval fund provides limited liquidity to its investors by offering to repurchase a portion of the shares on a periodic basis, investors should consider shares of a tender offer or interval fund to be an illiquid investment; therefore, an investment subject to liquidity risk. There is no guarantee that an investor will be able to tender all or any of their requested fund shares in a periodic repurchase offer.

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