

# Building on Real Estate

Tap into the potential diversification benefits for DC participants

**R**eal estate strategies may offer an effective way for defined contribution (DC) plans to help further strengthen retirement outcome potential. So why are they so underrepresented in participant portfolios?

While the three most important things in real estate may be location, location, location, the recent stock market upheaval serves as a reminder that managing volatility exposures in retirement plans is often all about diversification, diversification, diversification. Selecting the right mix of investment options remains one of the most useful tools plan sponsors have to help smooth out the potentially damaging effects extreme market gyrations may have on long-term retirement outcomes.

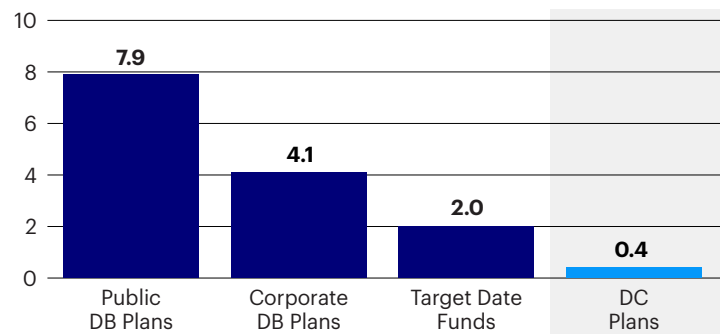
Unfortunately, most DC plans continue to be overly dominated by traditional asset classes — particularly US equities — despite the wide availability of DC-accessible alternative investment options that historically have proven beneficial in both lowering portfolio risk exposures and helping limit the range of potential participant outcomes. Consider real estate investments. The asset class has long been considered an effective way to diversify a well-balanced portfolio.

Yet, while real estate strategies (both public and private) have been available for DC plan inclusion for decades, the asset class remains largely underweighted in

participant holdings. Real estate offerings are available in 21.2% of large DC plans and represent a minuscule 0.4% of overall DC plan assets outside of target date funds, which also has a generally low overall 2% exposure to real estate. Compare that to similar retirement plans from abroad, such as Australia's more developed DC system that, on average, held real estate allocations of 8%, including 5% dedicated to direct real estate securities.<sup>1</sup>

## Average real estate allocations (%)

A missed opportunity?



**DB plans:** Pensions & Investments, "Real estate still the core real asset for US defined benefit investors," March 8, 2022, data as of December 31, 2021. **Target date funds:** Callan Target Date Fund Index, as of March 31, 2022 (an equally weighted composite of 64 target date fund series). **DC plans:** Callan DC Index, as of March 31, 2022 (analysis of 100 large DC plans representing \$400 billion in assets).

## Additive investment characteristics

It is easy to see why real estate assets remain a strategic part of so many institutional portfolios, with average allocations of 10.7%.<sup>2</sup> Backed by physical commercial or residential properties, these securities offer the potential for capital appreciation as the value of their underlying assets grow, historically providing attractive growth opportunities, the potential hedge against inflation and generating steady, predictable income. Because of these attributes, real estate investments can often react differently than traditional assets to changing economic cycles, which can potentially help them add resiliency to an overall portfolio.

Strategy choice has also expanded. Plan sponsors can now select from a large variety of direct and public real estate investment trust (REIT) solutions. Both overall segments have provided strong long-term track records of attractive risk-adjusted performance. For example, for the 20-year period that ended June 30, 2022, the broader direct real estate and REIT markets delivered annualized total returns of 8.98 and 9.33%, respectively, comparable to US equity returns of 9.14%. However, direct real estate's higher Sharpe ratios indicates better risk-adjusted performance.

## Performance, volatility and risk-adjusted returns

Annualized performance for the 20-year period ended June 30, 2022

	US Equity	Non-US Equity	US Fixed Income	Direct Real Estate	REITs
Total Return %	9.14	6.25	3.57	8.98	9.33
Standard Deviation %	17.25	19.56	3.92	4.80	21.89
Sharpe Ratio	0.46	0.26	0.61	1.62	0.37

**Sharpe ratio** is a measure of risk-adjusted returns. **Standard deviation** measures the degree to which the performance of a portfolio varies from its average performance during a specialized period. Asset classes reflect returns for the following indexes: Russell 3000 (US Equity); MSCI ACWI ex USA (non-US Equity); Bloomberg US Aggregate Bond (US Bonds); NCREIF Property Index (Direct Real Estate); FTSE NAREIT All Equity REITS (REITs). It is not possible to invest directly in an index. Performance for indexes does not reflect investment fees or transaction costs. Results may be significantly different for other time periods. **Past performance does not guarantee future results.**

Even more compelling from a portfolio risk mitigation perspective are the low- to mid-level correlations real estate assets historically have exhibited relative to traditional asset classes, as well as to one another. Over the past 20 years, direct real estate has offered strong diversification attributes with only a 0.12 correlation

to US equities and -0.22% to US fixed income. REITs also have provided broad low correlations, though they have been somewhat more closely aligned with stock market movements, given their typical share structure and the fact that many are traded on major public exchanges.

## Correlations between direct real estate and major asset classes

For 20-year period ended June 30, 2022

	US Equities	Non-US Equities	US Fixed Income	Direct Real Estate	REITs
US Equities	1.00	0.90	-0.07	0.12	0.76
Non-US Equities	0.90	1.00	-0.03	0.09	0.69
US Fixed Income	-0.07	-0.03	1.00	-0.22	0.12
Direct Real Estate	0.12	0.09	-0.22	1.00	0.23
REITs	0.76	0.69	0.12	0.23	1.00

Correlation is the relationship between distribution of returns between two data series. Asset classes reflect correlations for the following indexes: Russell 3000 (US Equity); MSCI ACWI ex USA (non-US Equity); Bloomberg US Aggregate Bond (US Bonds); NCREIF Property Index (Direct Real Estate); FTSE NAREIT All Equity REITS (REITs). It is not possible to invest directly in an index **Past performance does not guarantee future results.**

## Selecting a real estate strategy

Offering a real estate option in a DC plan menu or for inclusion in a multi-asset portfolio can depend on a number of factors. First, plan sponsors must consider the type of real estate strategies that make the most sense.

- **REITs:** Strategies that invest in public REITs are widely available as either actively or passively managed portfolios through a range of mutual funds and collective trust funds (CTFs). They also have historically been generally more volatile and more closely linked to stock market performance than direct real estate strategies.
- **Direct real estate:** Advancements in portfolio design have made it easier for plans to access daily valued, daily tradable strategies consisting predominantly of direct real estate holdings, with smaller REIT and cash exposures, usually built specifically for the DC market through a CTF structure. These tend to offer greater diversification benefits than REITs alone because direct real estate returns have been generally less tied to the traditional equities and fixed income securities that typically dominate DC plan allocations. Plus, their low correlation to traditional stocks, bonds and cash can help enhance risk-adjusted returns.

Individual strategies in both categories can vary significantly in terms of style, holdings, and potential volatility and return characteristics. This is reflected in the average return dispersions across strategies, which has offered the ability to capture notable outperformance opportunities through careful manager selection.

Key evaluation inputs include manager specialization, experience, and performance in both good and bad markets. It is also important to evaluate the asset manager's research capabilities, risk management approach, and sector and subsector exposures, given the specific risk/return attributes that can be associated with various real estate segments. For example, REIT index funds may be more exposed to the retail sector based on underlying benchmark holdings versus many actively managed strategies.

### Did you know?

The Department of Labor confirmed that plan sponsors could prudently offer alternative assets as part of a diversified investment option and offered clear guidance on how to document strategy selection.

This includes malls and outlets, and shopping centers, which are presently more challenged than other types of real estate segments.

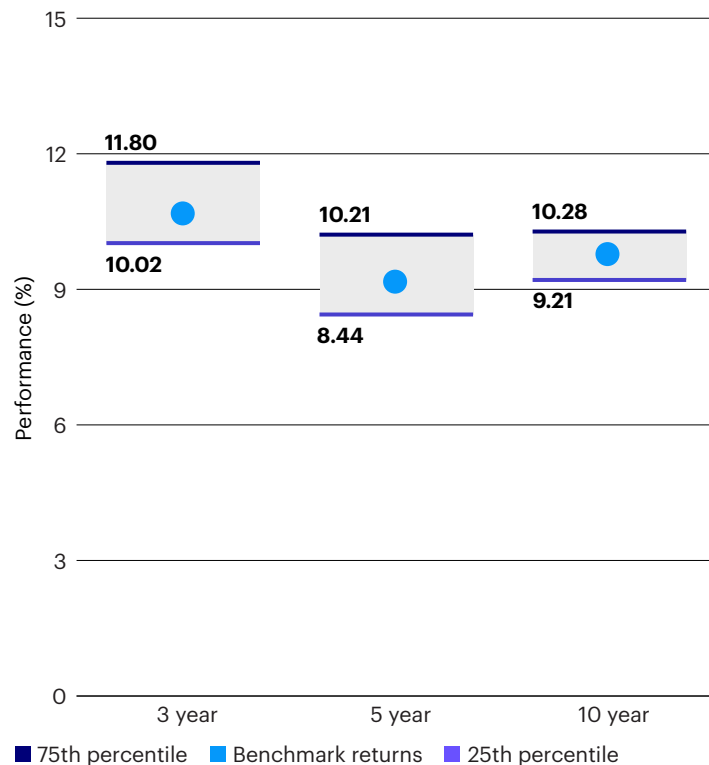
Direct real estate portfolios also involve an added degree of operational nuance that should be carefully considered, as managers must address the valuation and liquidity needs of DC plans. Questions to ask include: What is the valuation process? How is it implemented? How well documented is it? How does the manager address the liquidity and cash flow needs of DC plans?

### Criteria for comparing different portfolios/managers

- Manager style, experience and track record
- Sector and subsector exposures
- Regional exposures
- Supporting balance sheets
- Risk management approach

## The importance of manager selection

Range of annualized returns



MSCI/PREA U.S. ACOE Quarterly Property Fund Index (Unfrozen), Distribution of Direct Unleveraged Real Estate Performance as of 2Q 2022. An investment cannot be made in an index. Index performance does not reflect investment fees or transaction costs. **Past performance does not guarantee future results.**

## Addressing participant adoption rates

Despite their potential additive benefits, real estate strategies are simply not being utilized by most plan participants. A large part of the challenge appears to be in how they have typically been used in plan menus and presented to participants.

- **Core menu options:** Standalone REIT options in core menus are relatively common in plan line-ups but appear to be often misunderstood by participants, as demonstrated by their very low usage. Plus, many direct real estate strategies are not offered as a standalone investment option. A more realistic core menu approach may be as part of a prepackaged real assets portfolio. This can help participants enhance diversification with a broad, professionally managed allocation across a wider range of real assets, including infrastructure securities, commodities and, in some portfolios, Treasury Inflation-Protected Securities (TIPS).
- **Target date and target risk funds:** Real estate allocations continue to be adopted by a growing number of customized and off-the-shelf target date and target risk funds. This may be the most useful way to help participants gain access to the asset class, particularly when it comes to direct real estate. Though, as previously mentioned, average exposure is only 2%, it may make sense to increase exposure as glide paths approach retirement, due to the diversified income generation and inflation protection attributes of real estate assets.

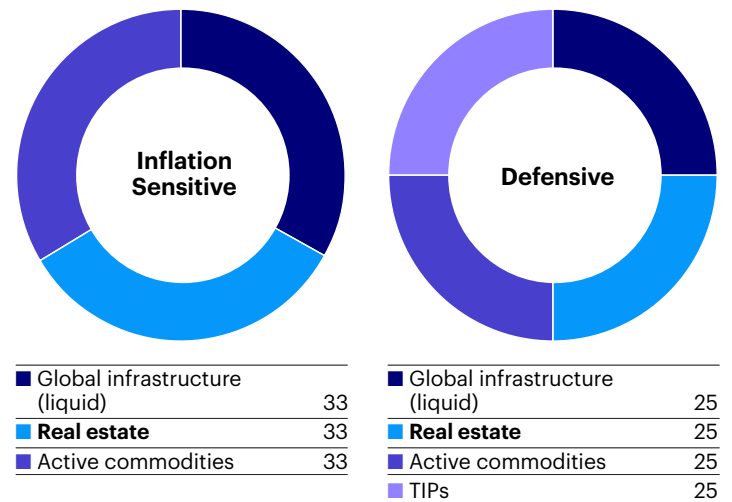
Ultimately, the best way to drive constructive behavior is to make it easy for participants to tap into the potential benefits real estate assets can provide to a well-diversified portfolio.

## Effective implementation of real estate in DC menus:

- **Core investment menus:**  
Strategic allocations in custom real assets portfolios
- **Target date/target risk funds:**  
Allocations typically increase as participants approach retirement

## Real estate in real assets portfolios

Sample model allocations (%)



For illustrative purposes only. This information is not intended as a recommendation to invest in a specific asset class or strategy.

## Conclusion

For plan sponsors looking to enhance diversification and help limit the range of participant outcomes, real estate investments can offer an effective lineup addition, especially when used as part of a prepackaged multiasset portfolio. Today, plan sponsors can choose from a wide selection of time-tested REIT and direct real estate strategies in an effort to help better prepare participants for retirement.



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1. ASFA, Superannuation Statistics August 2022, data as of June 30, 2022.
2. Institutional investor allocation based on 2021 Institutional Real Estate Allocations Monitor by Hodes Weill & Associates and Cornell Baker Program in Real Estate (survey participants number 224 institutional investors from 37 countries with over \$13.4 trillion USD in total assets and \$1.2 trillion USD in real estate assets).

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A target risk fund is a type of asset allocation fund that holds a diversified mix of stocks, bonds and other investments to create a desired risk profile. The fund manager of a target risk fund is responsible for overseeing all the securities owned within the fund to ensure that the level of risk is not greater or less than the fund's target-risk exposure.

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The **NCREIF Property Index** measures the investment performance of a very large pool of individual commercial real estate properties acquired in the private market for investment purposes only.

The **FTSE NAREIT All Equity REITs Index** is a free-float adjusted, market capitalization-weighted index of US equity REITs.

The **MSCI/PREA U.S. ACOE Quarterly Property Fund Index (Unfrozen)** measures the total returns of open-end, core diversified, commingled real estate funds invested in the US.

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