Perspectives

Core Real Estate: opportunities to enhance returns and lower risk

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U.S. Core Real Estate investments continue to deliver consistent total returns with a stable income component, at a relatively low risk point. Economic theory suggests steps taken to enhance core returns further would come with associated higher risk – the risk/return trade-off. New research from CBRE Investment Management indicates by harnessing the power of diversification across real estate strategies the opposite can be possible: a real estate allocation split between Diversified Core, Logistics and Credit has the potential to increase total returns, reduce risk and moderate volatility.

The investment world is defined by choice – Fund A or Fund B; growth strategy or income strategy; lower risk or higher reward. Trade-offs must be navigated before an appropriate balance can be found. Investors, it seems, cannot have the proverbial “cake and eat it.” But what if they could? What if investors could choose between one strategy that is proven to deliver high stable returns across the cycle at relatively lower risk and another which promises to enhance those same returns without increasing, but rather reducing risk?

When it comes to real estate strategies, investors do have that choice. CBRE has found that adding allocations to Logistics and Credit strategies not only enhances Core returns but also provides greater downside protection and diversification benefits. Logistics, with its long-term structural drivers, such as e-commerce and supply chain reconfiguration, together with favorable supply/demand dynamics, accounts for the capital growth side of the equation; Credit, with its contractual cashflows secured against high-quality assets, provides enhanced income and downside protection.

Over a trailing 20-year period, CBRE’s research shows that a real estate weighting split equally between U.S. Core, Logistics and Credit funds would have generated a material uplift in risk-adjusted returns. With growth subsectors such as logistics and residential forecast to be among the top-performers in real estate over the 2022-2026 period, CBRE expects this enhanced risk-adjusted return profile will likely be sustained for portfolio's that are overweight to these sectors.

Actual allocations between Core, Logistics and Credit will depend on each individual investor’s objectives – if an investor is growth focused then a higher weighting to Logistics and Core would be appropriate; if an investor needs more income, then a higher weighting to Credit and Core would be called for. Whatever the respective allocations, maximizing the opportunity requires careful selection of Core, Logistics and Credit strategies – a Logistics fund focused on modern cutting-edge facilities over one with legacy assets at risk of obsolescence. Get the fund/strategy right and investors can beat the risk/return trade-off and “have their cake and eat it.”

Core characteristics

What is core real estate?

Physical condition of properties, location, occupancy levels, creditworthiness of occupiers, length and terms of leases, loan-to-value ratio – the above are key criteria that all real estate strategies consider. Conservative and income-driven, Core real estate is largely focused on Class A properties that are in prime areas and are occupied by creditworthy tenants on long-term leases. In keeping with the conservative bias, leverage is only modestly deployed—typically less than 40% loan-to-value.

Defensive to the Core

Occupying the defensive end of the real estate risk spectrum, Core, unsurprisingly, offers defensive qualities:

- **Strong and stable income**: long-term leases with creditworthy tenants deliver predictable income; over the past 20 years, Core has generated an annualized income return of 5.9% which, accounting for approximately two-thirds of total returns, has a smoothing effect on the overall volatility of returns
- **Attractive risk-adjusted returns**: a favorable risk and return profile has historically combined to generate high risk-adjusted returns
- **Potential inflation hedging**: land values and rents typically rise with inflation, offering a degree of protection against price rises
- **Diversification**: over the 25-year period ending December 2019, Core had a low correlation with equities (0.16), high yield (0.14) and bonds (0.11) - based on average annual returns and the NFI-ODCE benchmark

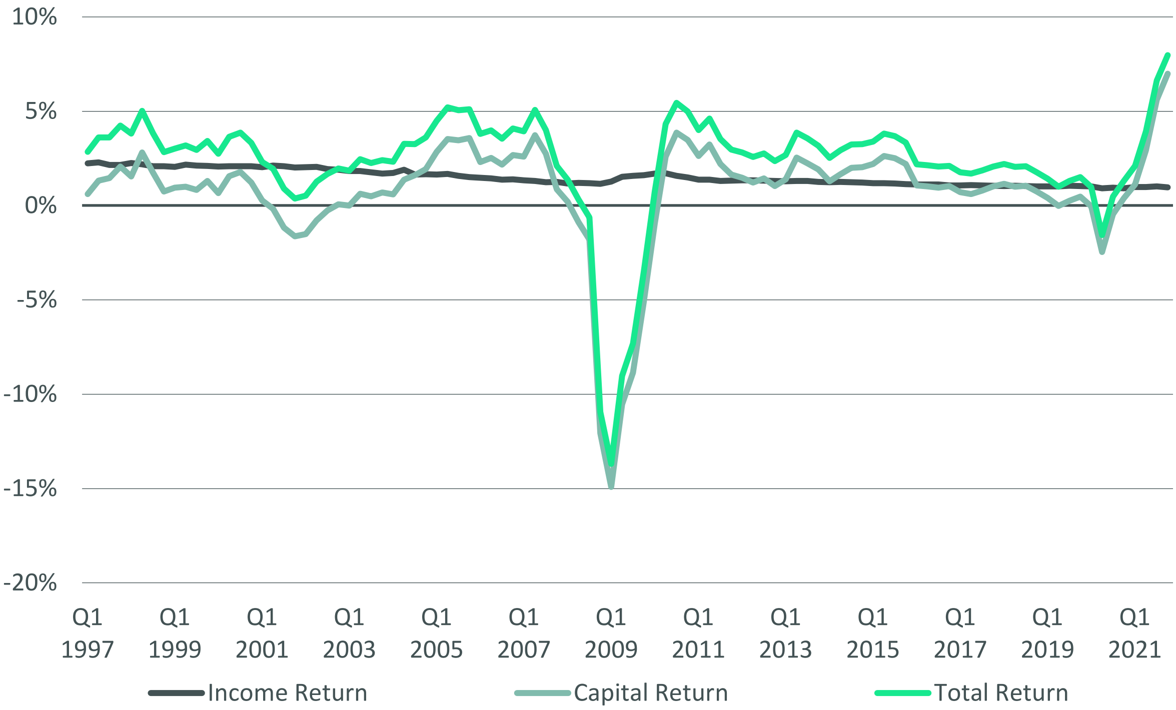
Source: https://www.cbreim.com/-/media/project/cbre/bussectors/cbreim/im/case-for-core-real-estate-in-daily-priced-multi-asset-solutions/us-core-in-multi-asset-class-portfolios.pdf

Core Real Estate: Income-Driven

	1yr	3yr	5yr	10yr	20yr
Income Return	4.2%	4.3%	4.4%	4.9%	5.8%
Capital Return	13.0%	3.9%	3.2%	4.3%	2.8%
Total Return	17.7%	8.4%	7.8%	9.3%	8.7%

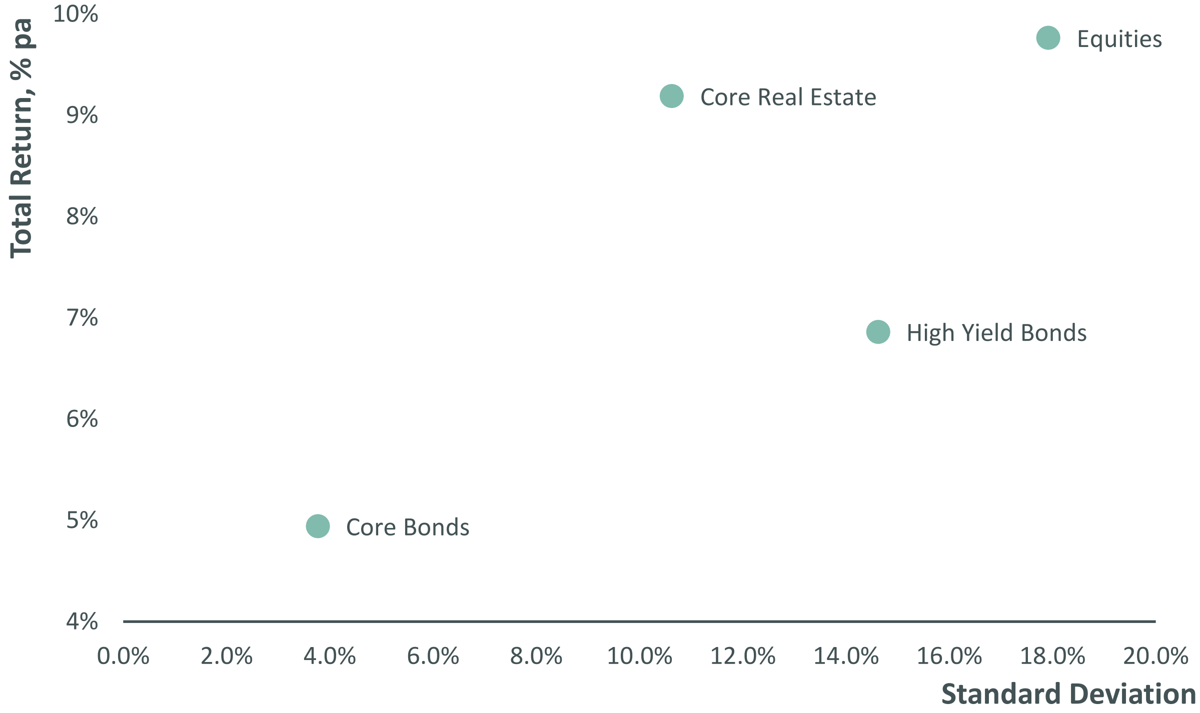
Source: NFI ODCE-Gross of Fees, as of December 2021

Core Estate: Stable Income



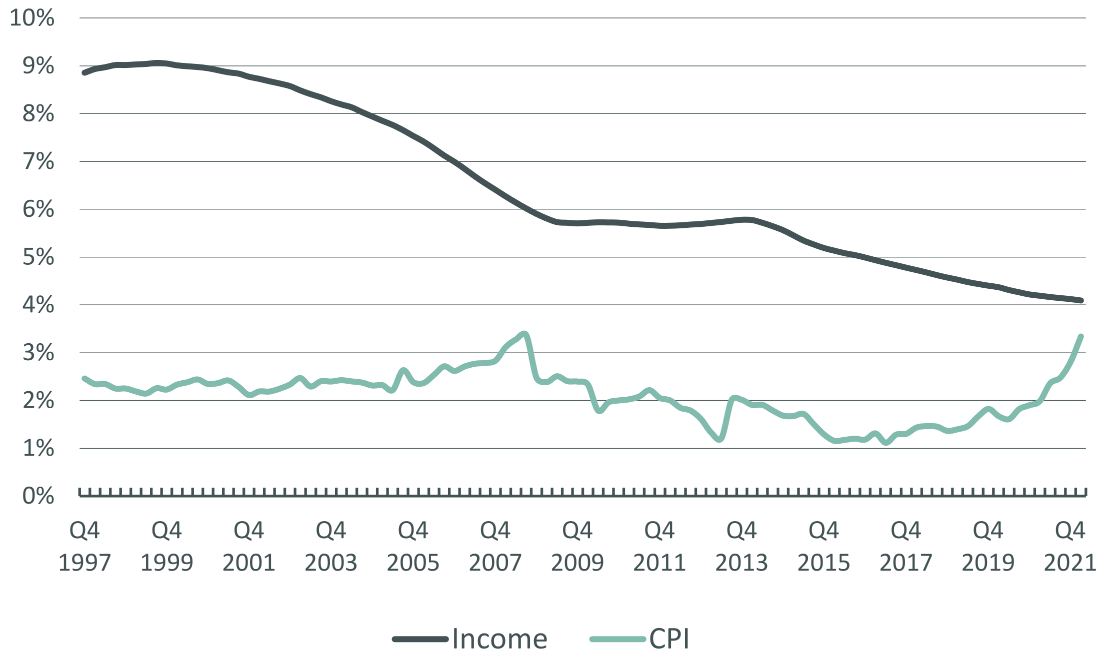
Source: NFI ODCE-Gross of Fees, as of December 2021

Core Real Estate – Attractive Risk-Adjusted Returns



Source: NFI ODCE-Gross of Fees, as of December 2021

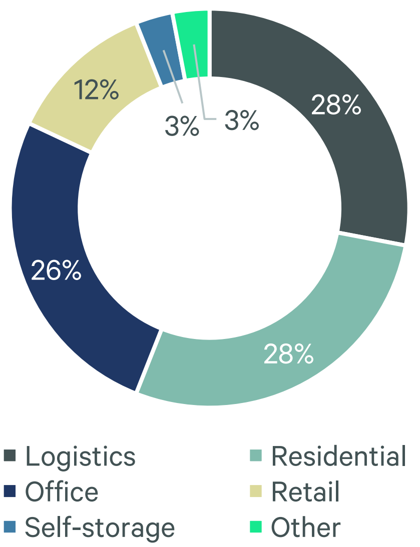
Core Real Estate – Inflation-protection



Source: Rolling 5-year income returns and inflation, % p.a. from NFI ODCE-Gross of Fees, as of December 2021

Core sectors

Focused on high-quality assets in high-quality locations with high-quality tenants, Core strategies are not restricted to particular subsectors – a residential property or a modern logistics facility can both equally be deemed Core if they meet the key investment criteria. A glance at the widely-followed NFI-ODCE benchmark highlights how Core strategies invest across a broad range of subsectors:



Sector allocations within Core change over time. 30-40 years ago, for example, allocations to retail would have been much higher. In the 1980s-1990s, shopping malls would have been considered Core investments. Today, with e-commerce transforming the retail landscape, the Core qualities of malls are increasingly under scrutiny. On the other hand, e-commerce has had a positive impact on logistics and distribution, hence today NFI-ODCE has a significant weighting to logistics.

Core has delivered

At the index level, Core has delivered what has been expected of it – high and stable real returns at relatively low risk.

On a trailing 20-year basis, the NFI-ODCE has generated net total returns of 7.3% per annum and for more than 75% of the time, total returns have outperformed U.S. inflation (CPI) by more than 300bps. The returns have also come with relatively low risk – volatility of 11.5% and a Sharpe Ratio (a measure of risk-adjusted returns) of 0.52. Meanwhile the Maximum Drawdown (the maximum loss from peak to trough experienced) was -37.8%, a period that included a financial crisis as well as a pandemic.

Focused on prime properties in prime areas with high-quality tenants on long leases, investors can expect Core to continue to generate stable returns – provided the selected strategy is forward-looking with sector allocations and incorporates cycle-awareness into risk management.

Not all Core funds are equal

The NFI-ODCE is a composite index of open-end private real estate funds pursuing a Core investment strategy. Currently, the index is comprised of 27 funds. No two funds are the same. Among the 27 are those funds that have embraced so-called “ODCE 2.0” or “ODCE 3.0” active allocation approaches – that is underweight traditional office and retail and overweight logistics and residential (ODCE 2.0), as well as other growth sectors (ODCE 3.0) such as self-storage, cold storage, data centers, student housing, single family for rent and life science. Other funds, by contrast, are less actively managed compared to the index and so are overweight retail and office.

A fund run by a skillful manager who invests in the right sectors, the right assets at the right leverage levels can benefit from diversification plus alpha. This is where a Core fund’s returns can be increased without increasing risk.

The case for getting more from Core

Different Core funds deploy different strategies and so generate different risk/return profiles. Some managers look to generate higher returns by adopting active allocation approaches such as ODCE 2.0 or ODCE 3.0. But what if there was a real estate strategy that not only delivered higher returns but also lower risk and lower correlation to other asset classes? Standard economic theory would suggest otherwise. Higher returns typically come with higher risk – the risk/return trade-off. And yet, CBRE has found a real estate solution that delivers on both counts.

We call this concept the Income and Growth Strategy. By adding Credit and Core+ Logistics exposure to an active Core strategy, investors can enhance capital and income returns and improve downside protection and diversification.

Enhance capital growth – by selecting a Logistics fund/strategy that maximizes the opportunity presented by the structural tailwinds driving the sector, such as e-commerce and supply chain reconfiguration with modest exposure to develop-to-hold assets.

Enhance income & downside protection – by selecting a credit fund/strategy secured against high-quality assets with significant headroom against value declines. Inflation protection can be particularly enhanced by investing in strategies centered around residential-backed cashflows.

Capture diversification benefits – by capitalizing on the low correlations of annual returns between Core, Logistics and Credit strategies, as detailed in the graphics below.

2011-2020, 10 Year - Correlations of Annual Total Returns

	U.S. Core Funds	U.S. Logistics Funds	U.S. Credit Funds
U.S. Core Funds	1.00		
U.S. Logistics Funds	0.37	1.00	
U.S. Credit Funds	-0.17	-0.06	1.00

2001-2020 - 20 Year - Correlations of Annual Total Returns

	U.S. Core Funds	U.S. Logistics Funds	U.S. Credit Funds
U.S. Core Funds	1.00		
U.S. Logistics Funds	0.93	1.00	
U.S. Credit Funds	-0.30	-0.32	1.00

A comparison of the 10 and 20-year time periods highlights the recent de-coupling in performance between Logistics and wider Core sectors – the correlation between U.S. Core and U.S. Logistics funds has fallen from 0.93 in the 20-year timeframe to 0.37 over the 10-year period. A key reason for this is the emergence of long-term themes that are driving the outperformance of Logistics.

Sources: U.S. Core Funds: NCREIF ODCE index net of fees, U.S. Logistics Funds: NCREIF NPI Industrial levered to ODCE LTV, U.S. Credit Funds: Blend of Giliberto-Levy High-Yield Commercial Real Estate Debt (G-L-2 Index) and Giliberto-Levy Commercial Mortgage Performance Index Levy (G-L-1 Index), G-L-1 Index is levered to 50% LTV, Real Estate Debt Cost: NAREIT T-Tracker Debt Cost, Credit Debt Cost: U.S. 3M LIBOR +100 bps. 20 years of annual data through December 31, 2020, returns are as of 21Q1 and net of fees. Fees for U.S. Logistics and Credit Funds are assumed to be 100 bps on NAV.
The above is for informational purposes only and does not constitute investment advice or a recommendation to purchase any security. There can be no guarantee any such allocations or targets will ultimately be achieved or that they will be appropriate or available for any investor. Subject to further refinement based on CBRE Global Investors evaluation and assessment, additional research and specific investor objectives. There can be no guarantee any such allocations or targets will ultimately be achieved.

Why Logistics?

As with all asset classes, drill down into the sector and there are winners and losers. Among the Logistics winners in recent years have been cutting-edge modern facilities—enablers of the e-commerce revolution. As well as being located in populated areas with excellent access to transportation networks, these facilities deliver the capacity, technology, flexibility and efficiency that enable online companies to keep to the promise of "same day delivery." Demand for these assets, which are increasingly built to ever-rising ESG standards, is high. Supply meanwhile is struggling to keep pace, especially as other structural drivers, aside from e-commerce, are at play.

One of these is supply chain reconfiguration. Pre-pandemic, successful "just-in-time" strategies encouraged businesses to keep levels of stock on hand to a minimum. Working capital positions were bolstered while operations/production lines continued uninterrupted. COVID-19 upset the balance. Lockdowns and other restrictive measures blocked the flow of goods. "Just-in-time" could no longer guarantee timely delivery. With stock levels at the bare minimum, the risk of having to shut down operations became a real one for many businesses. The result? Businesses are increasingly looking to hold more inventory - holding more stock is considered worth the extra cost if it helps to retain customer loyalty; it also acts as a hedge against inflation. This requires more space. "Just-in-case" supply chain strategies are therefore another source of long-term demand for modern logistics facilities.

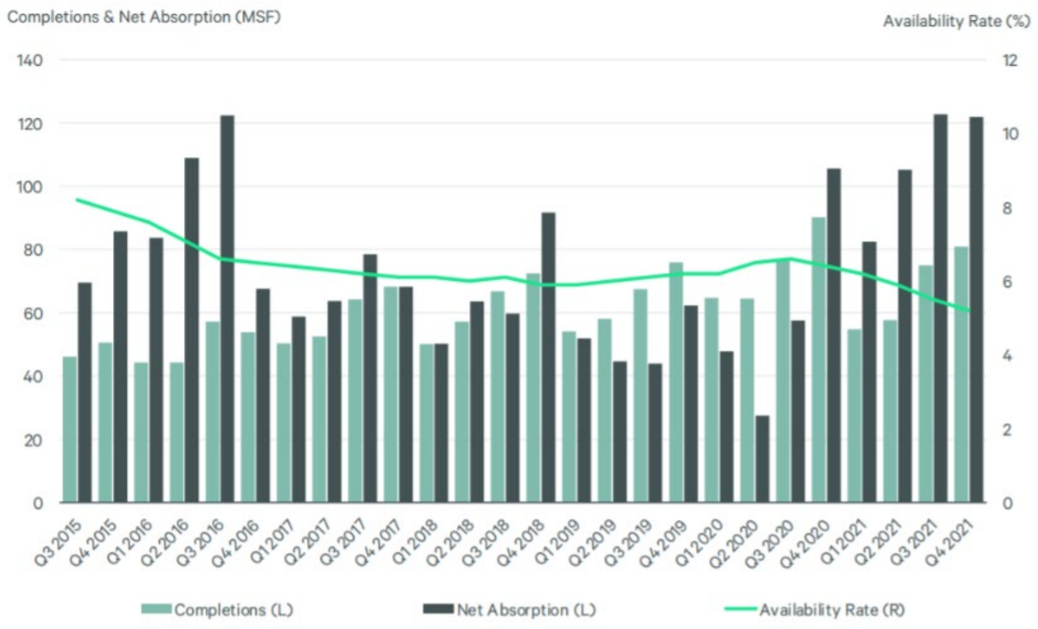
So too are soaring transportation costs, another indirect effect of the pandemic. According to Drewry Supply Chain Advisors and the Cass Freight Index, the cost to ship goods via ocean freight jumped by more than 200% in 2021, while the cost for domestic freight rose over 40%. The price rises may prove to be temporary, but the volatility seen has demonstrated the business risk posed by high transportation costs, especially as they make up 40-70% of a company's total logistics spend. By contrast, fixed facility costs, which include rent, account for only 3-6% per CBRE's Supply Chain Advisory. Leasing more space offers a cost-effective route to reducing transportation costs and at the same time protects businesses from any future supply chain disruption.

The effects of these long-term demand dynamics are being felt in the market. Average asking net rents for modern logistics facilities in the U.S. hit all-time highs in 2021 – CBRE estimates rental growth at the national level came in at over 10%. Meanwhile over one billion sq. ft. of leasing activity was completed in the U.S. during the year. With U.S. e-commerce penetration rates at the 20% level and the roll-out of "just-in-case" strategies at an early stage, the sector's strong performance is set to continue.

CBRE estimates e-commerce growth and supply chain reconfiguration alone are expected to require up to 330 million sq. ft. and one billion sq. ft. of new space respectively by 2025.

Supply is picking up. According to CBRE, a record 513.9 million sq. ft. of space was under construction in the U.S. as of Q4 2021, though this includes projects that broke ground in 2020/2021 but were unable to be completed due to COVID-19 disruptions. As the graphic on the next page shows, construction deliveries continued to recover in Q4, but were still 10.3% lower year-over-year and remained considerably lower than the net absorption rate. Even with new supply at elevated levels it remains outstripped by demand.

U.S. Competitions & Net Absorption vs. Availability Rate



Source: CBRE Econometric Advisors Q4 2021

Picking the right logistics strategy

Logistics is a growth story that has much further to run. That does not mean every Logistics fund/strategy will position itself to maximize the opportunity. While modern logistics facilities represent the winners in the sector, there are also losers which need to be avoided - legacy assets that do not have the specifications e-commerce companies or third-party logistics (3PL) providers need and those that do not meet higher ESG standards. As a result, legacy assets are, at best, unlikely to participate fully in the sector's expected outperformance in the years ahead and, at worse, run the risk of becoming obsolete. Avoiding outdated properties is a must for investors.

So too is selecting a Logistics strategy that is able to participate in new development opportunities and development-to-core assets projects, thereby negating the need to take part in competitive auctions that can lead to overpaying for assets.

And then there is the market itself. U.S. Logistics is comprised of multiple markets, each with their own supply/demand dynamics and profiles - the tables on the next page highlights the different net absorption and growth rates of individual U.S. industrial and logistics markets as well as levels of new construction.

Net Absorption

Ranking	Market*	MSF
1	Dallas/Ft. Worth (864.7)	39.6
2	Chicago (1,260.1)	35.5
3	Atlanta (664.0)	34.6
4	Pennsylvania/I-78/81 Corridor (485.0)	28.3
5	Houston (570.4)	28.0
6	Inland Empire (592.3)	22.8
7	Phoenix (355.1)	21.4
8	Columbus (281.8)	14.7
9	Los Angeles (948.0)	13.6
10	Memphis (272.8)	11.9

Growth Rate**

Ranking	Market*	MSF
1	Savannah	11.5
2	Central Valley, CA	8.2
3	San Antonio	8.1
4	Reno	7.2
5	Las Vegas	7.2
6	El Paso	6.4
7	Austin	6.2
8	Phoenix	6.0
9	Pennsylvania/I-78/80 Corridor	5.8
10	Louisville	5.7

Under construction

Ranking	Market*	MSF
1	Dallas/ Ft. Worth	54.5
2	Atlanta	35.1
3	Pennsylvania/I-78/80 Corridor	32.2
4	Phoenix	27.5
5	Inland Empire	22.5
6	Indianapolis	21.2
7	Chicago	20.5
8	Philadelphia	19.3
9	Houston	18.5
10	Savannah	17.7

Knowing the markets, understanding what occupiers need, accessing development opportunities – all are required to maximize on the U.S. logistics opportunity.

*Existing inventory MSF.
**Growth rate – YTD net absorption as % of existing inventory. Source: CBRE Research Q4, 2021.

Each market requires its own strategy – development-to-core assets activity may offer the most attractive risk-adjusted returns in supply-constrained markets; participating in new build projects may be the preferred strategy in markets where the spread between on-cost and market yields are wide; partnering with developers in areas where there is a high level of competitive tension helps secure access to off-market opportunities and capture the higher spreads on offer.

Why Credit?

Typically secured against underlying commercial and residential real estate assets, Credit comprises private loans and mortgages. The borrower uses loans to finance the acquisition of a property (acquisition financing), replace an existing loan which is maturing (refinancing), or fund improvements or development projects. The lender receives regular income from the loan interest payments, which are usually backed by rents from the underlying property.

The U.S. real estate Credit market is large - approximately $2.3 trillion worth of real estate loans will need to be refinanced over the next five years. The size and nature of the asset class gives it defensive attributes:

Stable, predictable income: the security of a contractual income stream gives investors visibility and relative certainty of income over time – generally, average commercial lease lengths exceed loan duration, useful for investors with long-term liabilities to meet.

Yield premium to fixed income: commercial/residential mortgages can generate a significant yield premium compared to corporate bonds or other fixed income products with similar risk characteristics.

Downside protection: real estate Credit can provide effective downside protection – loan covenants can generate early warning signals; lending can be limited to a percentage of the value of a property, ensuring there is a significant equity cushion in the event of value decline; priority over other lenders can be secured in the capital stack.

Backed by real asset security: commercial/residential mortgages take security over the underlying real estate, allowing a good manager to select high-quality assets and maintain their ability to attract tenants and preserve value.

Diversifier to direct real estate & securities: with only moderate correlation with traditional bonds, and low correlation with high-yield bonds and real estate equity, Credit offers valuable diversification benefits to investors and a defensive addition to a portfolio that complements a real estate equity allocation.

Short-duration risk offering protection against rising interest rates: loans are typically structured as floating rate notes with terms of five years or less. These characteristics enable the asset class to provide protection for investors in a rising interest rate environment as the coupon payment adjusts in line with changes in interest rates as well as allow for the regular recycling of capital from the return of principal into loans with higher rates.

Picking the right Credit strategy

Credit therefore offers the potential to enhance income and at the same time provides a portfolio with protection against falls in value as well as against rises in interest rates. But as with all asset classes, it is important to pick the right Credit strategy/fund, one that has a defensive orientation, is cycle-aware and focuses on current yield.

First and foremost a fund manager must select the right borrower and the right property to lend against. The two are inter-related – a borrower's ability to continue servicing interest payments on a loan typically depends on the rents that an underlying asset produces. As a result, location and property value are key. An understanding of the dynamics behind demand helps inform which properties will be more resilient to economic downturns, changes in working practices and which will be able to attract tenants over the long term.

A cycle-aware approach and current yield focus help insulate a fund against market downturns. This can involve targeting assets with contractual income in place that should ensure comfortable coverage of debt service and enable refinancing at maturity. In addition, loans can include covenants that allow the identification and management of risks as soon as they arise. These protections act as "levers to pull" in challenging markets and help identify risks well before they impact loan repayment.

Expert knowledge of real estate markets, an understanding of credit risk and the ability to effectively structure loans with protective covenants – all are essential to capitalizing on Credit's income enhancement and downside protection credentials.

Core/Logistics/Credit: a tailored income & growth solution

Combining Core, Logistics and Credit strategies not only generates an income and growth solution, but also one that can be tailored to the specific requirements of the investor. If an investor is more growth-orientated and prepared to accept a relatively higher level of risk, a larger exposure to a Logistics strategy can be sought. If an investor is more risk-averse, a higher weighting to Credit would provide more downside protection.

To varying degrees, any combination of the three strategies will capture the same benefits – provided the fund managers selected for each strategy have the skills to capitalize fully on the opportunities available:

- Diversification plus alpha
- Downside protection
- Higher exposure to growth sectors, such as Logistics, compared to the benchmark
- Improved portfolio performance - absolute and risk-adjusted

A case of AND not OR

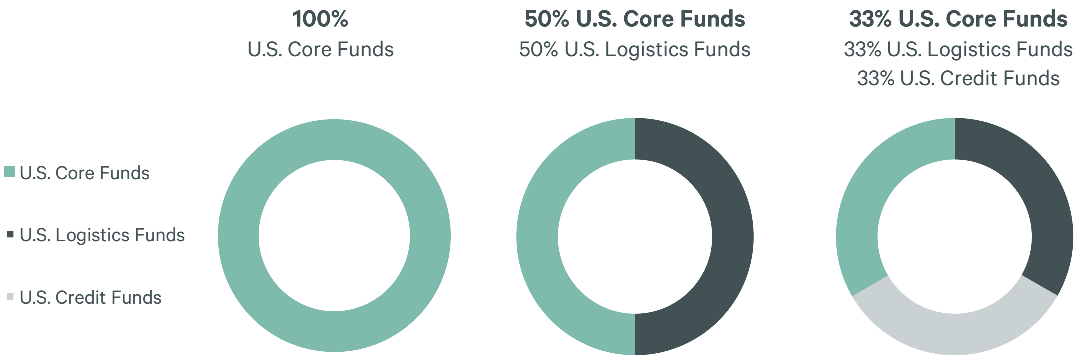
Income or growth; protection or growth – financial markets typically involve a trade-off.

A Core/Logistics/Credit strategy promises to replace the 'or' with an 'and' – income and growth; protection and growth.

The key is picking the right Logistics and Credit strategies to unlock the promise of enhanced growth/income and lower risk/volatility. Combine these with an active Core strategy that is forward-looking in terms of sector allocations, participates in development activity to capture the higher returns available and has the network and contacts in place to avoid overpaying, and the resulting Core/Logistics/Credit strategy can deliver higher reward AND lower risk and, in the process, debunk the risk/return trade-off.

Higher total returns, lower volatility, higher risk-adjusted returns (Sharpe Ratio), lower Max Drawdown, lower beta with Core funds, inflation protection – a Core/Logistics/Credit strategy delivers an income and growth solution with enhanced downside protection.

Higher absolute return with lower volatility



Trailing 20 year			
Total Return (net)	7.3%	9.0%	8.8%
Volatility	11.5%	11.8%	7.4%
Sharpe ratio	0.52	0.65	1.00
Max Drawdown	-37.8%	-37.6%	-21.3%
Beta with Core Funds	-	1.01	0.60
% of years O/P CPI + 3%	75%	85%	90%