The case for non-listed real estate in multi asset and in the real estate portfolio is even stronger than before

Executive Summary

This is an extract of the Characteristics of Non-Listed Real Estate in Investment Portfolio paper that explores in depth the important role of real estate in institutional investor portfolios. The research examines the benefits of investing in real estate in a multi-asset context, it explores the different routes available for accessing the asset class, their investment attributes and their role in real estate portfolio construction by sector/ geography and investment style, with a focus on non-listed vehicles. In addition it looks at evergreen issues of real estate conduits and secular trends shaping the industry.

Real estate has an important place in institutional investor portfolios. Strategic allocations to real estate can be justified on several grounds: diversification benefits within a multi-asset portfolio, attractive risk-return profile, a strong income component and inflation protection.

Our analysis demonstrates that non-listed real estate is an excellent proxy for the direct market, an excellent diversifier for bond heavy portfolios, and a better diversifier of equity risk than other alternative asset classes and listed real estate. Moreover, it exhibits relatively good risk-adjusted performance with low volatility and a solid and stable income return, as well as offering inflation protection to investors over a long horizon.

We review the different routes of accessing real estate and real estate portfolio construction across several dimensions: size, geography, sector and investment style. Direct real estate requires a large internal platform and sizeable capital outlay to achieve diversification. The indirect market represents a practical way to get exposure to the asset class, especially for small and medium-sized investors. Diversification could be achieved by investing in multi-country multi-sector indirect vehicles, which are more heavily represented in the non-listed universe. Single-country/ sector vehicles are another way to diversify an existing portfolio by choosing countries and/ or sectors within countries to which an additional exposure is needed. The majority of investors targeting European real estate use non-listed vehicles to access at least some of their allocation.

The non-listed sector has enjoyed significant growth by net asset value (NAV) and number of vehicles over the last decade. Its product offer has become more diverse in terms of geographical coverage and sectors – with non-traditional sectors attracting more capital – and investment styles, with open end diversified core equity (ODCE) and specialist equity funds as well as debt funds gaining traction. As a corollary, the industry has also become more mature especially, but not exclusively, in terms of liquidity, and transparency and governance.

Many institutional investors are below their target real estate allocations[1]. We should see an increase in both actual and target allocations to real estate, and non-listed vehicles in particular, given their attractive investment features and the low real bond yield environment. Higher future real estate allocations along with an increasing focus on operational real estate, ESG and impact investing should further expand the opportunity set for investors in non-listed real estate vehicles.

> ‘Non-listed real estate seems to be an excellent proxy for the direct market and an excellent diversifier in multi asset portfolios.’

[1] INREV Investment Intentions Survey 2021

Why Invest in Non-Listed Real Estate Vehicles?

Performance and diversification in a multi-asset portfolio

Diversification benefits within a multi-asset portfolio is the most important reason why investors invest in this asset class[2]. Listed real estate is often added to portfolios as a return enhancer and/ or for its liquidity properties within a real estate allocation, while private real estate is more viewed for its diversifier properties within a multi-asset allocation.

Evidence from the US market shows[3] that medium to long-term investors should allocate 10 to 20% of their portfolio to direct real estate and that open-end core vehicles are good substitutes for direct investments. For this reason, short-term investors should gain their real estate exposure through open-end core funds to avoid the high transaction costs of direct property investing. REITs, on the other hand, are considered as poor substitutes for direct investments, even over long horizons, and their weight in the real estate portfolio significantly decreases if core funds are considered too in conjunction with direct real estate. Moreover, the inclusion of other alternative investments in a portfolio does not meaningfully impact the allocations to real estate.

Table 1. Correlation between annual returns 2001-2019

	Bonds	Equities	Private Equity	Hedge Funds	Listed Real Estate	Non-listed Real Estate	Direct Real Estate
Bonds	1.00						
Equities	-0.24	1.00					
Private Equity	-0.24	0.95	1.00				
Hedge Funds	-0.22	0.74	0.73	1.00			
Listed RE	0.01	0.77	0.82	0.73	1.00		
Non-listed RE	-0.28	0.39	0.44	0.50	0.59	1.00	
Direct RE	-0.35	0.43	0.46	0.46	0.55	0.96	1.00

Source: INREV, MSCI, Bloomberg

[2] ANREV/ INREV/ NCREIF Investment Intentions Survey 2020

[3] Delfim, J.-C., & Hoesli, M. E. R. (2019). Real estate in mixed-asset portfolios for various investment horizons. Journal of Portfolio Management, 45, 141-158. [2] INREV Investment Intentions Survey 2021

The above performance and correlation tables provide further evidence on the favourable attributes of real estate[4] and non-listed vehicles in particular and their diversification benefits in a multi-asset portfolio. They show that:

- Non-listed real estate exhibits relatively good risk-adjusted performance and lower volatility than most other asset classes, but bonds and direct real estate
- It is an excellent proxy for the direct market
- Its link with listed real estate becomes closer for longer investment horizons
- Non-listed real estate is a better diversifier of equity risk than listed real estate or private equity and hedge funds
- It is an excellent diversifier for bond-heavy portfolios. This is an important finding for institutional investors in non-listed vehicles, such as pension funds and insurance companies, who have high bond holdings to meet their liabilities

Table 2. Correlation between annual returns 2010-2019

	Bonds	Equities	Private Equity	Hedge Funds	Listed Real Estate	Non-listed Real Estate	Direct Real Estate
Bonds	1.00						
Equities	0.29	1.00					
Private Equity	0.12	0.90	1.00				
Hedge Funds	-0.02	0.89	0.96	1.00			
Listed RE	0.57	0.82	0.78	0.71	1.00		
Non-listed RE	-0.42	-0.24	-0.07	-0.12	-0.08	1.00	
Direct RE	-0.29	-0.23	-0.08	-0.12	0.02	0.96	1.00

Source: INREV, MSCI, Bloomberg

[4] The analysis with the « desmoothed » private equity real estate indices, correcting for serial correlation/ artificially low volatility due to valuation smoothing, yileds similar results

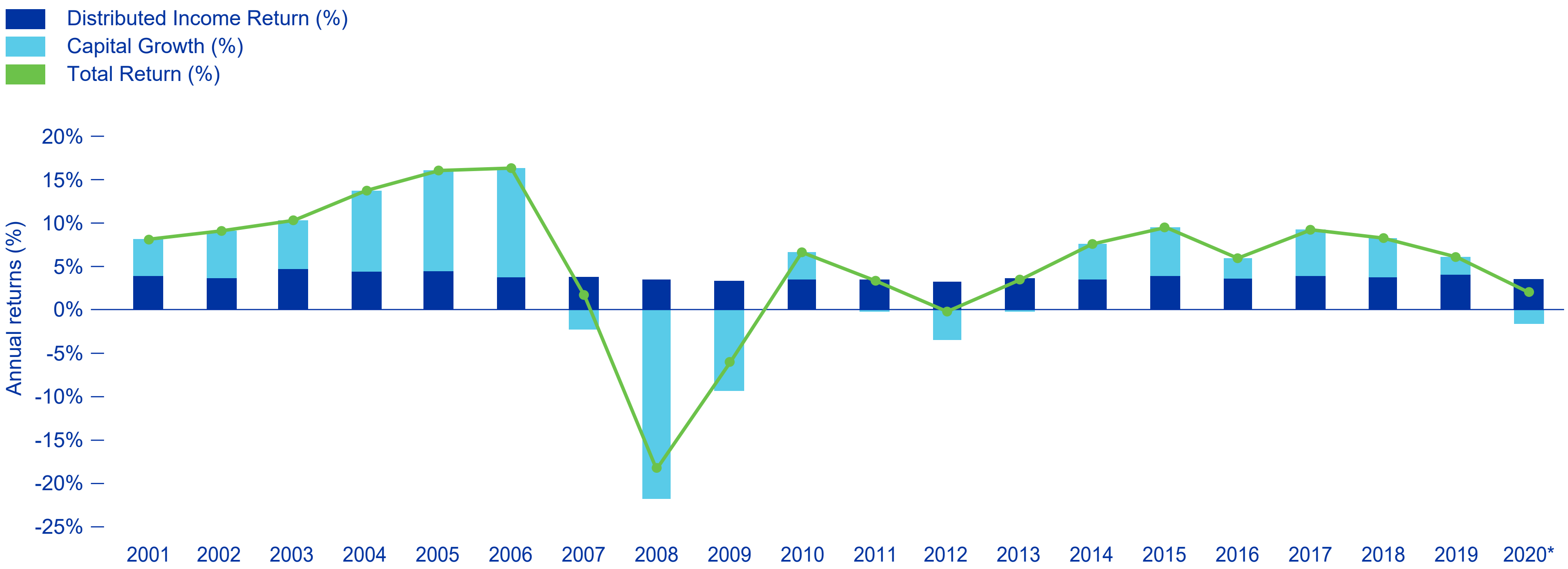
Attractive and stable income return

The attractive income profile of real estate is the second most important reason why institutional investors favour this asset class[5].

Non-listed real estate has offered a markedly higher income return than bonds over the last decade, making it very attractive to institutional investors. Going forward the consensus expectations are for low interest rates and bond yields over the next two years, especially in the Euro area. And there exists a significant buffer if bond yields start increasing, which should protect real estate returns.

Overall, the income return has been the most important and stable component of non-listed real estate performance in the long term, representing around 65% of the total over 2001-2019 according to the INREV Annual Fund index (see Figure 1 below). Investors with long investment horizons may partially protect themselves against the volatility of annual returns by holding real estate assets that feature a significant income component, as for example core assets.

Figure 1: INREV Annual Fund Index: return components



Source: INREV Annual Fund Index

[5] ANREV/ INREV/ NCREIF Investment Intentions Survey 2020

Inflation protection

Underlying real estate returns derive from both income and capital appreciation. Rental income is expected to be responsive to inflation, to the extent that inflation increases the nominal value of tenants cashflows and this feeds into nominal rents. The transmission dynamics and speed of rental adjustment may come with a lag and depend on the lease structure: typical lease durations, rent review periods and rental indexation. Short duration leases, for example, can provide better inflation protection enabling rents to adjust more quickly to inflation changes.

Real estate, however, is also subject to other risk factors such as GDP growth and supply shocks that make the relationship with inflation more complex (see Figure 2 below). A high GDP growth – low inflation environment is believed to be ideal for increased property allocations. Alternatively, a high GDP growth – high inflation scenario is also benign while a stagflation one (low growth – high inflation) is expected to be detrimental to property returns.

The balance of empirical evidence indicates that the degree of inflation protection varies between property sectors: residential properties are a good inflation hedge, office and industrial properties seem to offer a partial hedge, while the retail sector appears as the weakest inflation hedge. These findings can be explained by differences in lease terms, as well as specific secular trends underpinning rental growth.

Overall, at least in the long run, real estate performance moves in line with inflation. Investors can preserve and increase their real wealth by choosing to hold real estate assets over long investment horizons.

Figure 2: Likelihood of real estate offering inflation protection

Real estate portfolio construction

Investors, having first set their target allocation to real estate as an asset class, then seek to achieve diversification in their real estate portfolios by defining their strategy primarily in terms of geography and sectors, as well as investment styles. Direct real estate, at first glance, offers the widest universe. But in reality it is difficult to achieve diversification with direct holdings, as very few investors have large internal platforms with the necessary sector/ country expertise and capital required to build and manage a well-diversified international real estate portfolio. A valid alternative way to access the asset class is via the indirect market, either listed or non-listed.

Non-listed funds own the biggest share of EU commercial property investment, at around 30% of total, while EU listed property companies and REITs account for 20%[6]. Over the last two decades the evolution of the European non-listed equity real estate funds universe has been phenomenal both in terms of diversity of offer and growth. The INREV annual index in 2020 included 368 vehicles representing €216.8 billion NAV, up from 45 vehicles representing €16.9 billion NAV in 2001. The last decade also experienced the emergence and rapid growth of non-listed real estate debt funds, spurred by stricter banking regulations for bank lending to real estate, with other large institutional investors, such as insurance companies, bridging the real estate financing gap.

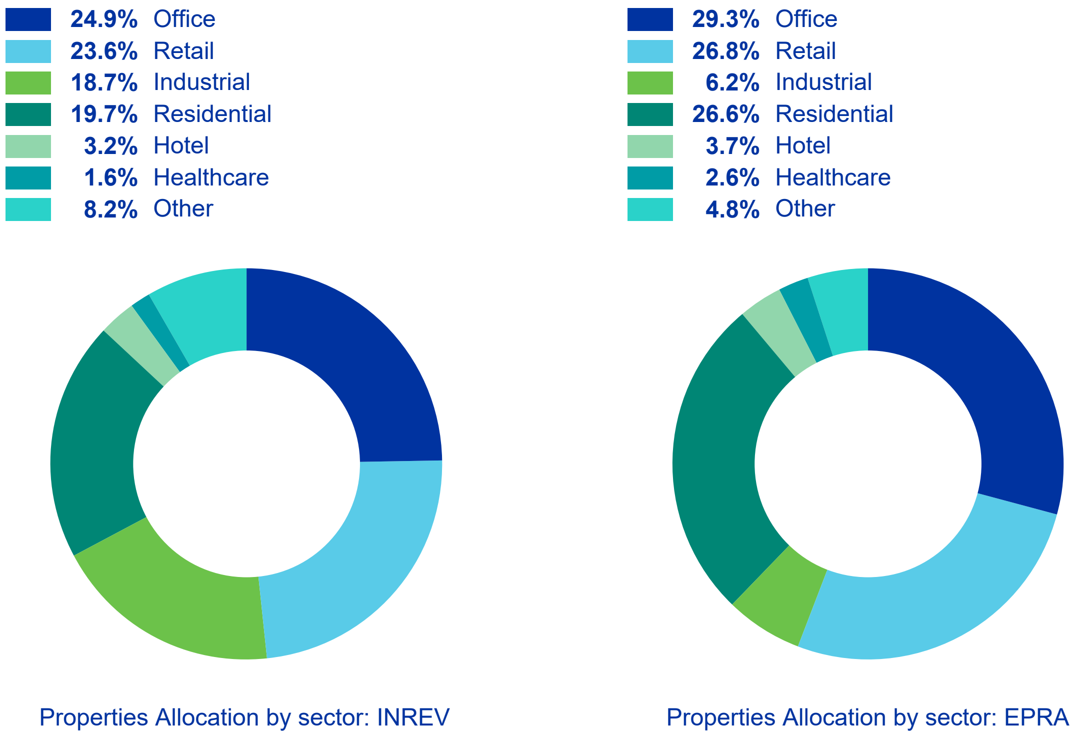
The European non-listed sector covers a broad universe in terms of geographies and sectors. Non-listed equity funds with a multi-country strategy account for 41% of NAV of the INREV annual index (2020). European listed vehicles, on the other hand, tend to be single country focused, with a few listed vehicles also investing outside their domestic market, but these investments typically represent a very small part of their portfolio. Moreover, the non-listed sector has a bigger offer of multi-sector vehicles than the listed one. Investors, therefore, may easily construct a diversified real estate portfolio by using non-listed multi-country multi-sector vehicles, with the additional advantage that their portfolio performance will be closely linked to that of ‘bricks and mortar’.

Portfolio construction, however, often comes with constraints, such as the investor’s existing portfolio and the availability of product to rebalance it in order to achieve the desired geographical and sector diversification.

‘Over the last two decades the evolution of the European non-listed equity real estate funds universe has been phenomenal both in terms of diversity of offer and growth.’

[6] Source: INREV/ EPRA Real Estate in the Real Economy, November 2020

Figure 3: Property portfolio owned by INREV and FTSE EPRA NAREIT Developed Europe constituents, end 2019



*Original categories have been simplified as in "Real estate in the real economy report" so that INREV EPRA portfolio composition is comparable

Source: INREV Annual Fund Index, EPRA (data from EPRA Market Research Paper “Sector Report Residential”, November 2020)

Investors can rebalance their existing real estate portfolio by choosing single-country, single-sector and / or multi-sector vehicles. However, the portfolio composition of the listed and non-listed industry differs across property sectors (see Figure 3). For example, industrial carries a higher weight in the INREV portfolio while residential has a higher share in the EPRA one so the optionality for portfolio construction may vary, depending on the sector and the preferred route. Often listed and non-listed investments could be regarded as complementary for achieving a target equity property portfolio exposure. The non-listed route also provides the option of executing more ‘tailor-made’ strategies and/or targeting specific real estate assets through segregated accounts, JVs and club deals, as well as co-investments.

As the non-listed funds market matured the range of products offered has widened. They can generally be divided into three main risk/return categories: core, value added and opportunity funds. Core equity funds are the most represented in the investment universe.

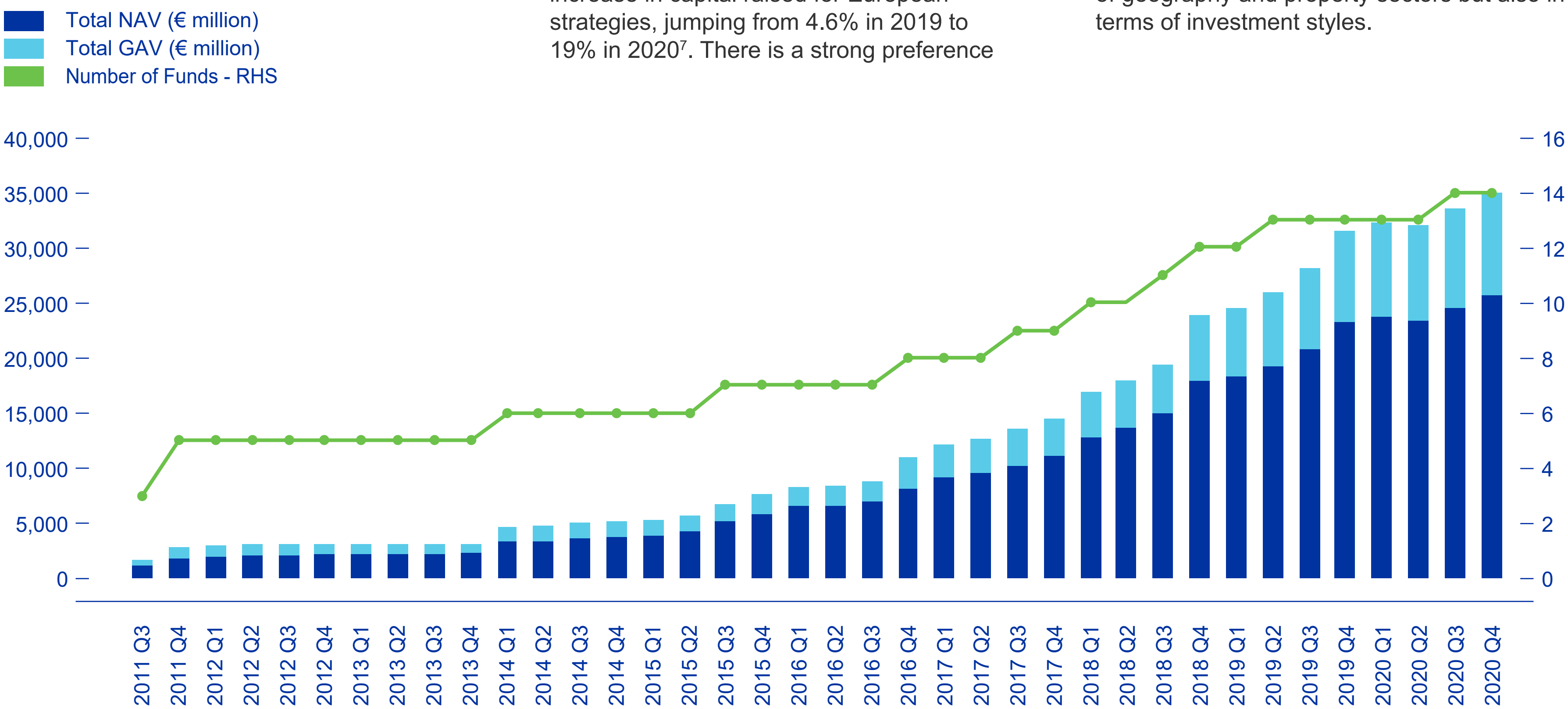
> ‘Often listed and non-listed investments could be regarded as complementary for achieving a target equity property portfolio exposure’

Open end diversified core equity (ODCE) vehicles (see Figure 4) stand out, with strong investors' appetite and significant growth potential. This is based on their ability to attract investors targeting passive, diversified, relatively liquid, stable income and low risk strategies with low fees. Closed end funds have higher risk strategies but may also be used as part of a core strategy targeting specific markets or sectors. Investment has been increasing in funds focused on alternative sectors such as senior housing, healthcare and student housing, which are supported by long-term underlying mega-trends.

Non-listed debt vehicles have been also gaining traction, accounting for the largest increase in capital raised for European strategies, jumping from 4.6% in 2019 to 19% in 2020[7]. There is a strong preference for senior debt strategies, which is due to their attractive attributes of stable income, downside protection, attractive risk-adjusted returns and in particular for the insurance sector potential for improved capital efficiency.

Overall, the non-listed sector offers a wide range of investment products. It allows for diversification within the real estate portfolios by defining property strategies both in terms of geography and property sectors but also in terms of investment styles.

Figure 4: Evolution of European ODCE funds



Source: European ODCE Funds Index

[7] ANREV/ INREV/ NCREIF Capital Raising Survey 2021

Features of European real estate vehicles

This section discusses evergreen issues of non-listed real estate, namely liquidity, and transparency and governance and the improvements that have been made in each area.

Liquidity
Illiquidity is inherent in the real estate asset class and some degree of illiquidity maybe desirable for long term investors. It comes with lower volatility and an illiquidity premium to be harvested. Investors in non-listed real estate assess its liquidity across two principal dimensions, the required time to enter/ exit an investment and realised trade value of it.

The illiquidity of non-listed real estate is a function of both the liquidity profile of the underlying assets and the structure of the vehicle itself, as well as the market specific liquidity. The open-end fund structure offers acceptable levels of liquidity to investors under normal market conditions by providing them instant access to a diversified range of assets and allowing them to redeem capital and exit the fund if and when needed. Close end funds are relatively illiquid, at least from a primary market perspective.

The relative illiquidity of non-listed funds can also be managed through the secondary market. Secondary trading in open end funds increases liquidity, as investors can bypass subscription and redemption queues. And it adds flexibility to close end structures by allowing existing investors to exit before fund termination by selling their units to new investors wishing to enter.

Secondary trading volumes have been growing fast, especially over the last five years. Historically, the UK trades dominated, but more recently we have also seen a significant increase in the secondary trades volume for European non-UK focused non-listed funds. In 2020 for the first time this surpassed the UK secondary trades volume and accounted for 58% of the total European and UK focused trades.

Overall liquidity in the non-listed sector has been improving, as can be evidenced by the levels of activity in the secondary market. The growth of European ODCE funds may further enhance liquidity in the non-listed sector, as these vehicles are infinite life and relatively large in size.

Transparency, governance and extent of investor control
The non-listed sector has achieved high levels of information disclosure and governance as the industry matured. INREV has always been around to improve transparency, professional and best practice. It started with the INREV Vehicles Database to help the industry understand what funds were in the market and how they were structured. Followed by many research studies and the INREV indices to give investors much better ways to evaluate fund performance. The INREV Guidelines brought consistency and best practice to the industry, followed by events and training courses to share insights and bring us together as a community.

We recognise the increased global nature of the industry and in parallel with the wide range of products INREV has been collaborating with relevant industry bodies in other regions[8] to further promote data transparency, best practice, harmonisation and accessibility to information on a global scale[9].

As the industry became more regulated INREV set up a public affairs team and office in Brussels. Regulatory requirements have further promoted information disclosure and governance. Following the GFC, regulatory authorities introduced the Alternative Investment Fund Managers Directive (AIFMD), a regulatory framework that applies to almost all EU- registered hedge funds, private equity funds, and real estate investment funds. Overall, the AIFMD has had a strong positive impact on the real estate industry with fund managers benefiting from “passporting”, a single approach to marketing in the EU market, and investors from higher transparency and disclosure of information, comparability and stronger corporate governance.

The legacy of the GFC has strengthened risk management in terms of governance, alignment of interest between investors and managers and investors and co-investors, and closer control over investment decisions.

[8] ANREV in APAC and both NCREIF and PREA in North America
[9] They have jointly established a Global Definitions Database (2017) and the Total Global Expense Ratio (2020), a harmonised measure of total fees and costs across regions and many global research studies.

Secular trends

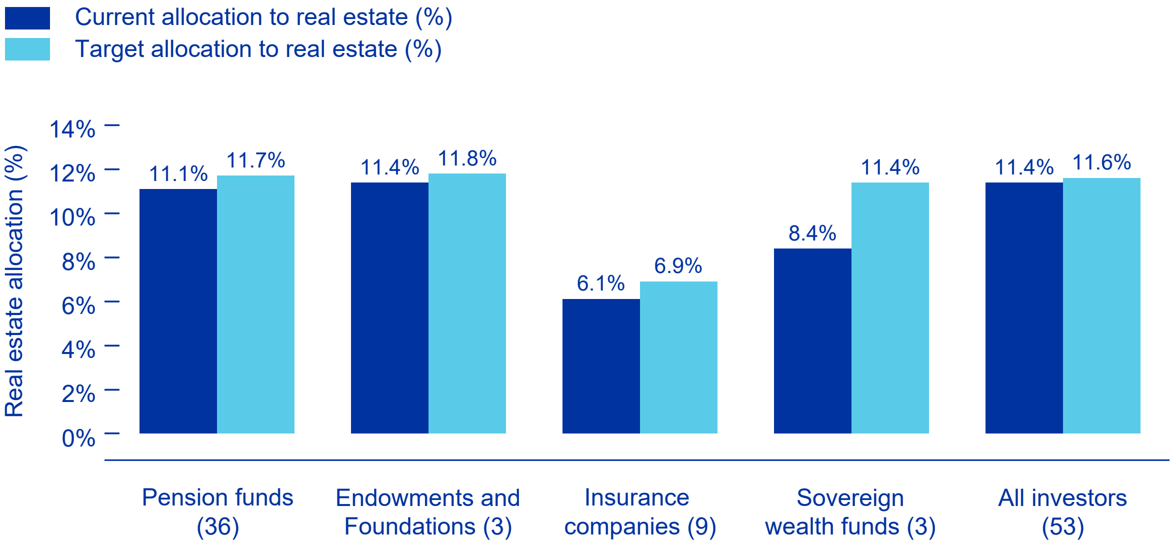
The future growth of real estate, and the non-listed sector in particular, as an asset class is underpinned by several favourable secular trends. Absolute and relative allocations to non-listed real estate are expected to continue rising. In parallel with the rising allocations to real estate, the increasing focus on operational real estate, ESG and impact investments will enlarge the investible real estate universe.

Global wealth and the share of AUM in global wealth are both rising and this result, by itself, is sufficient to boost demand for real estate. Moreover, real estate allocations for all types of investors are constantly increasing and this phenomenon is not expected to change any time soon. Many institutional investors, such as pension funds, insurance companies and SWFs are below their target real estate allocations and that is unlikely to change any time soon. (see Figure 5 below).

SWFs are the furthest below target, having an average current allocation of 8.4% versus a target of 11.4%. There is an argument that SWFs are likely to increase their exposure to real estate as they can more easily afford the illiquidity associated with the asset class when compared to more traditional investors. Another potential source of capital for real estate investments is represented by family offices and HNWIs. All in all, part of this capital will flow to non-listed funds, thereby supporting the growth of existing and new managers willing to enter this dynamic market.

> ‘Global wealth and the share of AUM in global wealth are both rising and this result, by itself, is sufficient to boost demand for real estate.’

Figure 5: Current and target allocations to real estate by investor type, weighted by total AUM



Source: INREV's Investment Intentions Survey 2021

ESG and impact investing

The real estate industry has acknowledged the importance of integrating ESG issues into investment decision making processes for achieving risk reduction, learning more about sustainability opportunities and protecting shareholder value.

There exists a growing recognition that efficient, sustainable buildings can yield higher returns by being more attractive to tenants and thus reducing overall vacancy and/ or supporting higher rental values. Furthermore, adopting ESG principles into investment decisions helps limiting the risks related to depreciation and/ or obsolescence of the assets and enhancing risk-adjusted returns. Long term investors should carefully consider the risks that might impact the value of their investments over long time horizons. All in all, energy efficient buildings should show higher risk-adjusted returns, albeit data quality is not robust enough to univocally demonstrate this assumption for different sectors and markets. Finally, it is believed that assets which comply with some ESG metrics are more liquid than the rest.

With the climate change emergency, many investors and investment managers are also assessing the impact of climate risks on their portfolios. According to World's Economic Forum Global Risks report 2021 climate related issues dominate the long- term risks in terms of likelihood. There is growing awareness and action to manage and mitigate physical risks of climate change and the risks associated with the transition to a low carbon economy.

In the last few years, accelerated by the Covid-19 pandemic, ESG focus has expanded into social and governance aspects besides environmental. Governance encapsules corporate governance and corporate behaviour. The governance of the non-listed sector has been greatly strengthened following the GFC as a result of both regulatory and institutional investors' more stringent requirements. The "S" in the ESG covers a wide-ranging array of social matters, including health hazards, diversity, equity and inclusion (DEI) policies and the involvement into community matters. Investors are pressing for new products adhering to ESG principles and managers are following suit.

In parallel, impact investing is also gaining traction among investors. The size of the impact investment market across asset classes now exceeds €600 billion[10]. At times, it is difficult to distinguish between ESG and impact investing. However, impact investing needs to have intention and clear objectives to create positive social and/ or environmental impact, together with the expectation of financial returns. It should have the core characteristics of 'intentionality', 'additionality' and 'measurement', in tandem with financial goals. Examples of social impact investing in real estate include housing, health and education.

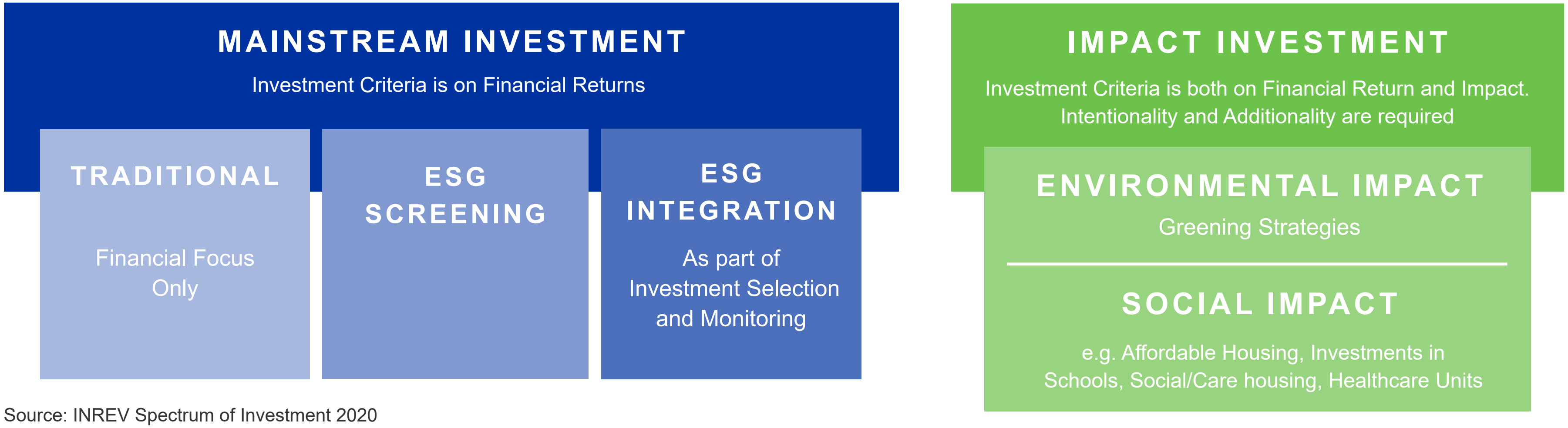
> 'Adopting ESG principles into investment decisions helps limiting the risks related to depreciation and/ or obsolescence of the assets and enhancing risk-adjusted returns.'

[10] GIIN "2020 Annual Impact Investor Survey"

To facilitate investors understanding of the different approaches to real estate investing, INREV has developed The Spectrum of Investment, i.e. a framework to map out different investment approaches for real estate, depending on investors' ambition for environmental and social impact (see Figure 6 below). These range from traditional investments (far left) to impact investing (far right).

The increasing importance of ESG and impact investments should further enlarge the opportunity set for investors in non-listed real estate vehicles.

Figure 6: Environmental and social ambitions



Source: INREV Spectrum of Investment 2020

Concluding remarks

It is widely accepted that real estate as an asset class has desirable investment attributes, such as attractive risk-adjusted performance, diversification potential in a multi-asset portfolio, a high and stable income return and a degree of inflation protection. This study reexamines the above arguments and demonstrates there is a strong case for both non-listed real estate in multi-asset portfolios and within real estate portfolios, and that the prospects look bright. The analysis shows that non-listed real estate exhibits relatively good risk-adjusted performance with low volatility and a solid and stable income return. It also is a better diversifier of equity risk than other alternative asset classes and listed real estate. Most importantly, it appears to offer a great diversification potential to portfolios with high bond holdings. Many institutional investors, such as pension funds, insurance companies and SWFs are below their target real estate allocations. We would expect an increase in both actual and target allocations to real estate, and non-listed vehicles in particular, given their attractive investment features and an ultra low real bond yield environment.

We have considered real estate portfolio construction and diversification across several dimensions: size, geography, sector, investment route and investment style. Portfolio construction comes with constraints, such as investors' existing portfolio and the availability of product to rebalance it to achieve the target portfolio across these dimensions. The growth of both listed and non-listed real estate markets over the last two decades has resulted in a proliferation of vehicles. Diversification for medium- and small-sized investors can be more easily achieved via the indirect market. Specifically, non-listed vehicles present the additional advantage that their performance is closely related to that of the direct market, as our findings indicate. A close examination of the non-listed universe reveals that it offers a wide range of options in terms of both geographies and sectors. If an investor is willing to invest in specific geographies and sectors, this is largely possible by acquiring exposure to non-listed vehicles. Different real estate investment routes, though, could also be treated as complementary for achieving a target allocation to the extent they offer some different pockets of exposure.

Non-listed real estate features a range of investment styles. The recent evolution of the non-listed real estate universe is largely driven by core strategies, such as the growing European ODCE and non-listed real estate debt segments, with a focus on senior debt. Their strong investment attributes are expected to drive further allocations to these vehicles. There are several reasons that make the case for non-listed real estate even more compelling than before. The non-listed industry has attained high levels of transparency and governance and has been rapidly embracing environmental and social ambitions. Liquidity has been improving, both through secondary market trading and the evolution of new products and investment structures. The investable universe is expanding its coverage in terms of geographies, sectors and investment styles. The increasing focus on operational real estate sectors, ESG and impact investments could further enrich the non-listed offer. Higher expected capital flows into the sector in conjunction with increased product options indicate exciting times ahead for investors and fund managers in non-listed real estate.