REAL ESTATE AS AN INVESTMENT FOR INDIVIDUAL INVESTORS – BEYOND THE PRIMARY RESIDENCE

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When presenting investors with the concept of investing in real estate within their defined contribution (DC) plans, some may argue that real estate—in the form of the family home—already comprises a significant proportion of their total wealth (and debt!). With that in mind, they may be wondering why they would consider allocating more of their assets to real estate.

For an aversion to further investment in real estate to be valid, owner-occupied residential real estate (i.e., the family home) would have to be more or less identical to commercial real estate in terms of its investment characteristics, as well as its expected risks and returns. If this were true, the underlying concern—namely, duplicating an existing exposure—would be entirely reasonable. Conversely, if other real estate exposures were materially different from residential real estate exposures, then they would be diversifying and could potentially improve the portfolio's expected return and/or risk characteristics.

So, are traditional commercial real estate exposures—public or private—substantially the same as residential real estate?

Before looking at numbers, let's consider the qualitative attributes inherent to residential real estate vs. commercial real estate:

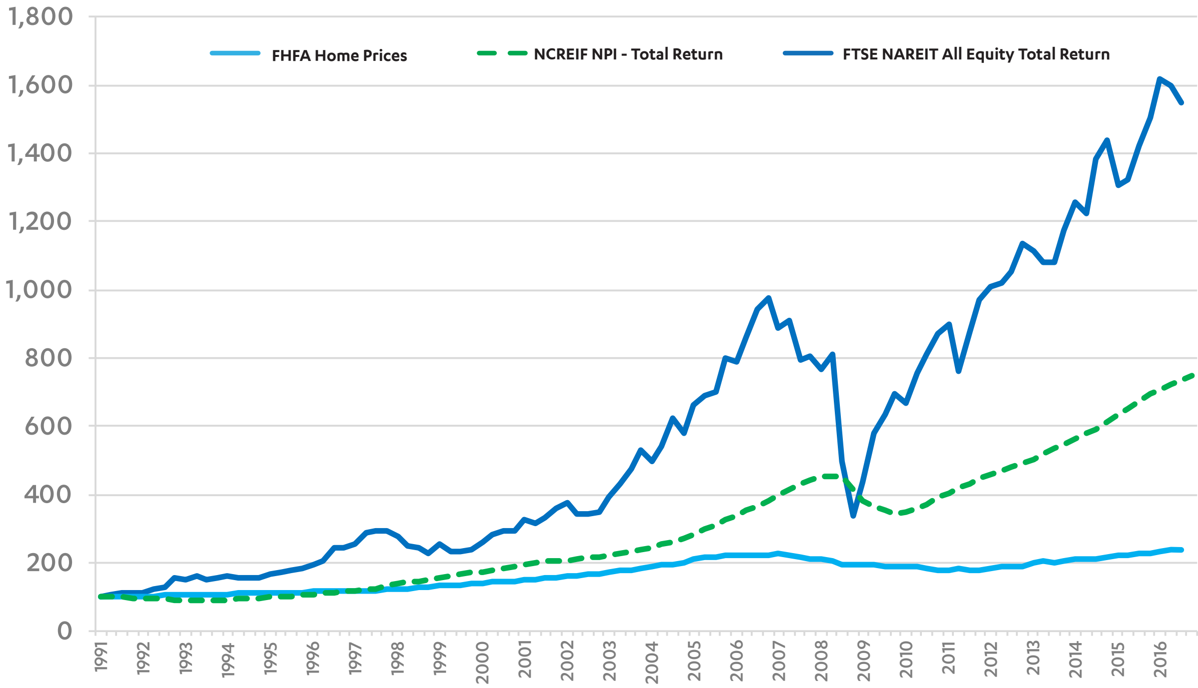
	RESIDENTIAL REAL ESTATE	COMMERCIAL REAL ESTATE
UNDERLYING USE	Used for the purposes of dwelling, and its value to the owner may not be fully incorporated into its price.	Used for profit-making activities and typically has a more direct link to the real economy.
RENTAL INCOME	Owner-occupied residential real estate provides no current income from rent.	Commercial real estate involves rental income, making it attractive to particular types of investors (e.g., those with ongoing income needs). When this income has a link to inflation, the underlying real estate is of particular value (e.g., for those with an inflation-linked liability).
	Both types of real estate have a capital gain (or loss, as the global financial crisis reminded us) component to be factored into a total return calculation.	
RISK	Residential real estate is highly unique. Its relative performance as an investment depends on the very specific set of demand and supply dynamics of a particular city or neighborhood.	Commercial real estate, accessed via public or private vehicles, tends to incorporate some measure of diversification, whether by property, geography, sector, etc. Some ways of accessing commercial real estate (i.e., REITs) also have additional benefits such as liquidity, although liquidity may also carry with it stock-like volatility.

After examining these qualitative characteristics, commercial and residential real estate appear to have their differences. So what do the numbers say? Recent research by East (2016) suggests that the returns may also be very different.

Analyzing 20 years of U.S. data, East (2016) found that REITs returned 11.23% a year. Of that result, about half (5.78% a year) was from rental income. Based on median house prices, East (2016) estimated a return to residential real estate of 3.47% per year, all from capital gain. That amounts to less than one-third of the total return earned on commercial real estate and not a great deal better than inflation over the same period (2.15% annually).

Comparison of Total Returns from Single Family Homes, Private Commercial Real Estate and REITs

1991 – 2016



Note: NCREIF NPI serves as a proxy for the performance of private commercial real estate.

Source: NAREIT analysis of FTSE-NAREIT All Equity Index (total and price returns) and NCREIF NPI via FactSet. FHFA Purchase Only Home Price Index.

The measured volatility of these returns may also differ depending on the vehicle used. While the underlying risks of a given portfolio of properties are identical whether they are accessed through public or private markets, greater price fluctuations may be observed in REITs. Such fluctuations may be offset by greater liquidity with REITs versus private real estate.

While East's 2016 findings use particular data over a set timeframe to compare the performance of residential real estate to commercial real estate, we believe the evidence suggests that other types of real estate may make sense alongside residential real estate in an investor's overall portfolio. Put another way, an individual who limits their investments to residential real estate may be forgoing a world of other real estate opportunities.

For more information and to read a more in-depth research study, visit www.dcrec.org/DCRECResearch

References

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