



Better Together:

*Pairing REITs and CORE Private Real Estate
to Strengthen Participant Outcomes*



KEY TAKEAWAYS

- Real estate has become a key investment component of the U.S. retirement market, historically offering expanded diversification, competitive investment performance over the long term and potential inflation-hedging attributes.
- In the past, DC plans have primarily accessed real estate exposure through REIT strategies; however, a growing number are now also including core private real estate investments.
- Research shows that expanding real estate diversification to include both core private real estate and REIT allocations can enhance retirement portfolio risk/reward characteristics across a broader range of market cycles.
- This approach can offer participants a smoother performance ride and strengthen long-term outcomes, by providing a historically attractive yet more stable return profile with complementary sector exposure.

ABOUT DCREC

The Defined Contribution Real Estate Council (DCREC) is an organization of investors, consultants, investment managers, attorneys, recordkeepers and other businesses dedicated to improving outcomes for DC plan participants through the investment of retirement assets in direct or securitized real estate. DCREC member firms represent over \$1.5 trillion in total real estate assets including an estimated \$79 billion invested in daily valued real estate products. DCREC focuses its efforts on advocacy and education while acting as a clearinghouse for industry best practices and creative and innovative solutions that seek to help plan sponsors and their advisors better meet the needs of retirement investors.

Learn more at www.dcrec.org.





INTRODUCTION

For decades, defined benefit (DB) pension plans have been successfully allocating to real estate assets, both publicly traded and privately held securities, within their investment portfolios. This is because most DB pension plans consider real estate a fundamental asset class with unique investment attributes and return drivers and believe it should be included as part of well-diversified portfolios along with stocks, bonds and cash.

The defined contribution (DC) world has been rapidly catching up with the DB world in terms of investing in real estate and for good reason. Several studies have found that DC plans have tended to underperform DB plans and determined that a key driver has been due to the fact that certain asset classes often used in DB plans, such as real estate, have not always been made available in DC plans.¹

Indeed, most DC plans have added real estate exposure to their professionally managed multi-asset-class strategies, such as target date funds (TDFs) and white label funds. However, to date, most have relied on strategies that invest in publicly traded real estate investment trusts (REITs), also referred to as “listed REITs,” to do so. In contrast, DB pension plans typically include exposure to strategies that also invest directly in privately held real estate. This “better together” approach to expanding real estate diversification has historically helped to enhance portfolio risk/reward characteristics across a broader range of market cycles and strengthen long-term outcome potential.

In the past, there were a number of practical reasons why DC plans tended to focus on REITs for real estate exposure, related to issues such as daily valuation and liquidity. However, advancements in DC real estate strategy design have made realizing the potential benefits of pairing both publicly traded REITs and core private real estate increasingly accessible to DC plans of all sizes.

This paper explores how this type of real estate investment approach may help strengthen participant outcomes over the long term.

¹ Examples include studies conducted by the Center for Retirement Research at Boston College; CEM Benchmarking, a benchmarking firm in Toronto; and others.



WHY ADD REAL ESTATE TO RETIREMENT PORTFOLIOS?

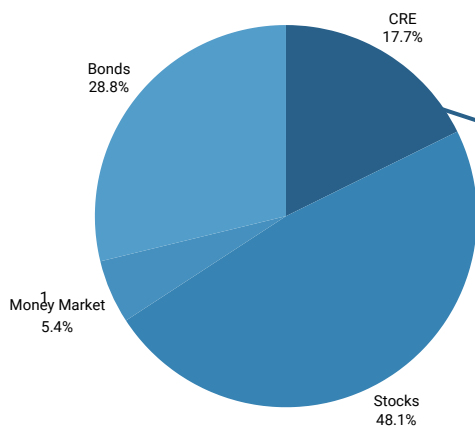
A Major Investment Market

While real estate is usually classified as an alternative asset, it is also one of the largest asset classes available to investors, with U.S. commercial real estate assets representing an \$18.5 trillion investment universe, only behind U.S. stocks and U.S. bonds in terms of overall market size. By far, the largest component of this segment encompasses private equity assets (i.e., direct, privately held real estate investments), although it also includes public equity (largely publicly traded REITs) and both public and private debt (see Exhibit 1).

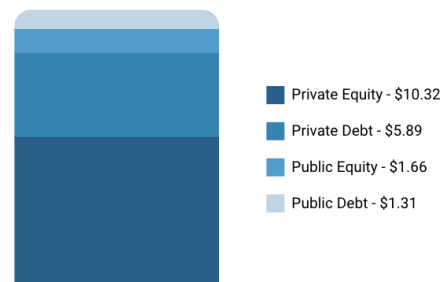
EXHIBIT 1: U.S. COMMERCIAL REAL ESTATE IS THE THIRD LARGEST ASSET CLASS IN THE U.S. FIGURES AS OF FOURTH QUARTER 2023

Figures as of Fourth Quarter 2023

U.S. MARKET INVESTMENT UNIVERSE²



U.S. COMMERCIAL REAL ESTATE UNIVERSE³ (\$ TRILLIONS)



Historically Additive Investment Characteristics

Real estate offers a significant, well-established market with a long history of well-documented, additive investment characteristics:

- *Expanded diversification* with a distinct economic cycle relative to traditional stocks and bonds, which can help reduce performance correlations and dampen portfolio volatility.
- *Competitive, long-term investment returns* driven largely by historically attractive, and steadily growing, income from rents, plus potential for moderate capital appreciation over time.
- *Potential inflation-hedging attributes* given that many leases are tied to inflation and that real asset values tend to increase in response to rising replacement costs.

These diversifying attributes can be even more important in helping to build greater portfolio resiliency in an environment characterized by persistent inflation and more frequent positive correlations between equities and fixed income during periods of drawdowns.

² Source: Property and Portfolio Research (PPR), Wilshire 5000, Barclays US Universal.

³ Source: Federal Reserve, NAREIT, CoStar.



WHY ADD REAL ESTATE TO RETIREMENT PORTFOLIOS?

Broad adoption across retirement portfolios

Given the points above, it is unsurprising that real estate has become a key investment component of the U.S. retirement market.

- *Employed by most DB plans in their strategic allocations:* More than 90% of DB plans that incorporate assets other than stocks, bonds and cash invest in both listed and/or private real estate assets.⁴
- *Recommended by most advisors across investors' working careers:* As shown in Exhibit 2, an industry study researching allocation recommendations for individual investors at various stages of their careers found that more than 80% of advisors suggest including REITs in the range of 4% to 12%, on average, irrespective of the client's age, from early career through retirement, largely for the potential diversification benefits.⁵ This research may be directly linked to retirement investing because frequently these allocation recommendations are made in connection with Individual Retirement Account (IRA) assets so it has a clear application to DC participants, who are investing across their careers and many of which may not have any major additional investments outside of their DC plans.

EXHIBIT 2: REPRESENTATIVE ADVISOR RECOMMENDED REAL ESTATE ALLOCATIONS BY CAREER STAGE

An industry survey conducted by Chatham Partners in 2021 asked advisors, "What percentage of your client's portfolio do you generally recommend is allocated to REITs in each stage of their working life?"

	Early Career (<40)		Mid-Career (40-54)		Pre-Retirement (53-65)		At Retirement (>65)	
	Maximum	Minimum	Maximum	Minimum	Maximum	Minimum	Maximum	Minimum
TOTAL	12%	4%	12%	5%	12%	5%	12%	5%
Fee Based Advisors & RIAs								
High Net Worth	8%	4%	8%	4%	9%	4%	9%	4%
Mass Affluent	13%	3%	13%	4%	13%	5%	12%	5%
Broker-Dealer & Wirehouse Advisors								
High Net Worth	13%	5%	14%	6%	13%	6%	14%	6%
Mass Affluent	12%	5%	13%	5%	13%	6%	13%	5%

⁴ Preqin.

⁵ 2021 Chatham Partners survey.



WHY ADD REAL ESTATE TO RETIREMENT PORTFOLIOS?

- *Included in most DC plans:* A significant portion of DC plans have added real estate investment options on a standalone basis as part of their core investment menus, although overall participant investment in these strategies has been minimum, at less than 2% of overall DC assets. Of more importance is the large number of DC plans that have incorporated the asset class within their asset allocation offerings, such as TDFs. In most of these cases, this exposure has been initially gained through a REIT strategy. As evidence of this, based on an analysis using industry data, the share of TDFs with REIT exposure increased from 50% in 2003 to nearly 100% in 2019.⁶ In addition, 61% of TDFs used in the U.S. now have a dedicated REIT sleeve within their asset allocation.
- *Progression toward expanding DC real estate diversification:* Of note, there currently appears to be a growing trend in DC plans to expand from purely REIT-centric sleeves to also include core private real estate exposure. The number of plans including private real estate assets as an inflation-sensitive allocation in their custom TDFs has increased from just 3% in 2017 to 23% in 2021.⁷ Furthermore, seven off-the-shelf TDF series now include private real estate assets.

We see the move to include core private real estate assets in DC plans as a natural evolution as industry advancements continue to innovate. Publicly traded and private real estate assets can play complementary roles in portfolio construction by offering discrete risk/return profiles within the real estate segment. Together, they can help offer broader, more representative exposure and historically smoother investment performance across full market cycles. This can potentially help to further strengthen participant outcomes over the long term, as explored in the sections that follow.

WHAT IS A REIT?

REITs are a company that owns, operates, or finances income-producing real estate. REITs typically own a portfolio of properties, managing them to maximize long-term total returns and passing rental income along to investors in the form of corporate dividends. They can invest in a broad range of traditional property types, including retail centers, apartment buildings, office buildings, and industrial warehouses. In addition, the REIT industry has expanded to include infrastructure, data centers, timberlands, and single-family housing. These property types reflect the evolution of the changing U.S. economy.

⁶ Morningstar Direct.

⁷ DCIIA Retirement Research Center 2022 Custom Target Date Fund (cTDF) Study.



THE IMPORTANT ROLE OF PUBLICLY TRADED REITS

It is easy to see why DC plans have been drawn to REIT strategies for their real estate exposure. These offerings seek to provide many of the potential benefits of real estate investing with the ease and advantages of investing in publicly traded securities.

Designed to Capture Real Estate Investment Characteristics

Because these securities own and often operate income-producing real estate or related assets, their investment returns have tended to be generally aligned with the performance of the underlying properties over the long term. Since they are usually traded on public stock exchanges, they can be more sensitive to broader stock market volatility, especially over shorter time periods, compared to direct, private real estate investments, potentially diluting their diversification characteristics. As a result, the broader REIT segment has historically experienced drawdowns much more closely aligned to equity markets in periods of elevated volatility, compared to core private real estate, which has tended to be more stable when stocks have sharply declined.

Performance

Historically, REITs have provided strong performance. The trailing 25-year annualized total return of the FTSE Nareit All Equity REITs Index through December 31, 2023 was 9.5%.

Easily Accessible

Publicly traded REITs significantly reduce the barrier to entry for investing in real estate, as they are easy to buy and sell like any publicly traded stock. This also makes it easy to size allocations quickly and efficiently.

Highly Liquid

On a related note, publicly traded REITs are easy to buy and sell quickly, given that they can be traded any day the exchange they are listed on is open.

Broad Range of Strategies and Investment Managers

Today there are a wide array of REIT strategies to select from, ranging from broad market strategies to those that focus on specific real estate segments to passively managed portfolios to actively managed strategies to specific investment approaches or styles.

Price and Performance Transparency

Both publicly traded REITs and the professionally managed strategies that invest in them typically provide easy to track daily pricing and performance when markets are open.

Costs

REIT strategies are usually considered generally cost-efficient ways to invest in real estate. However, owning and managing all real estate has certain unavoidable costs. In core private real estate, this is reflected in the management fee; in REITs, it is reflected in their individual operating performance.



THE POTENTIAL BENEFITS OF ADDING CORE PRIVATE REAL ESTATE ALONGSIDE REITS

Although DC plans presently lag DB plans in their use of core private real estate, they appear poised to begin catching up rapidly. Investment innovation has helped to address the major historical barriers for DC plans to access core private real estate strategies on a larger scale, such as daily market valuation, liquidity and costs. Today, plans of all sizes can more easily access the segment, offering a range of potential benefits.

More Direct Real Estate Exposure

Core private real estate strategies represent direct investment in the underlying properties, rather than in a company managing a portfolio of properties, such as is the case in a REIT. Because these securities are not listed on publicly traded exchanges that are dominated by traditional stocks, they tend to be less influenced by short-term stock market moves.

More Reflective of the Overall Real Estate Market

As highlighted earlier in Exhibit 1, private equity assets represent by far the largest component of the U.S. commercial real estate market.

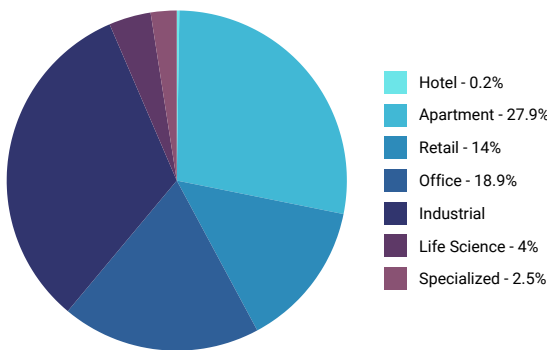
Complementary Sector Exposure

Core private real estate strategies are typically well diversified with a focus on more traditional property types and geographies, and utilize modest levels of leverage. The segment is defined as stabilized (well-leased), income-producing assets most commonly garnered from apartment, retail, industrial and office property types. The REIT segment typically consists of a more broadly diverse range of property types, including enhanced exposure to new growth sectors. In fact, as shown in Exhibit 2, more than 50% of the REIT market is represented by new and emerging property sectors such as data center and cell towers. Together, both types of securities can provide a more diversified portfolio of real estate assets.

EXHIBIT 3: COMMERCIAL REAL ESTATE TYPE DIVERSIFICATION

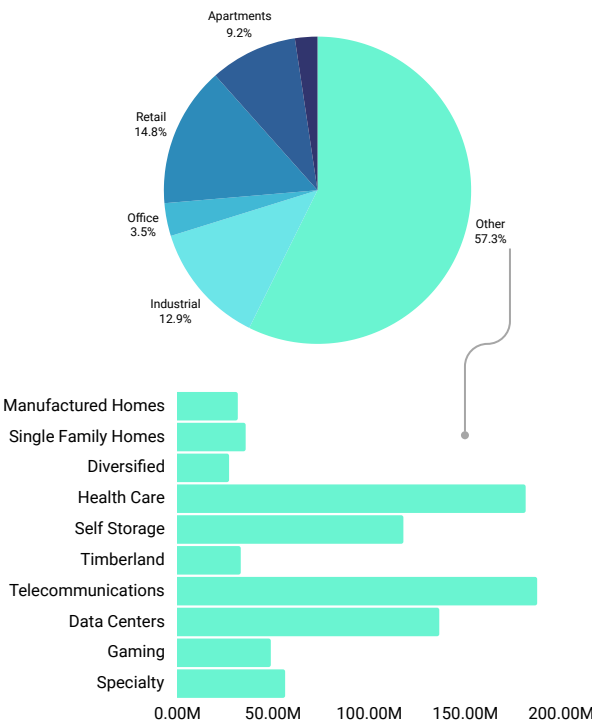
PRIVATE REAL ESTATE COMPOSITION

ODCE Composition by Market Value
Source: NCREIF, Principal Real Estate Investors, Q2 2024



PUBLIC REAL ESTATE COMPOSITION

FTSE NAREIT All Equity REITs Index Composition
Source: NCREIF, Principal Real Estate Investors, Q2 2024

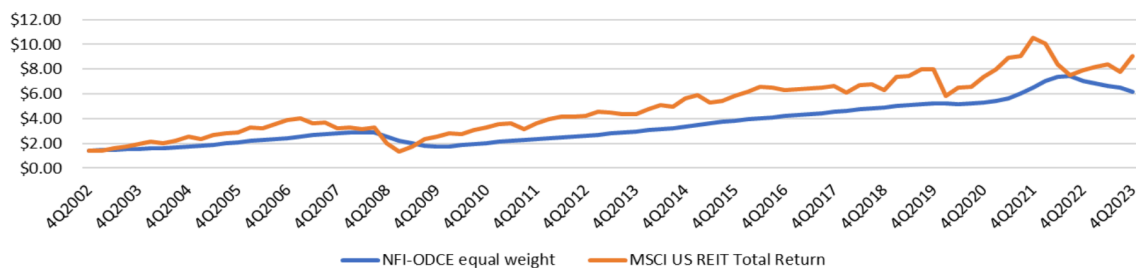


Historically more stable return profile versus REITs

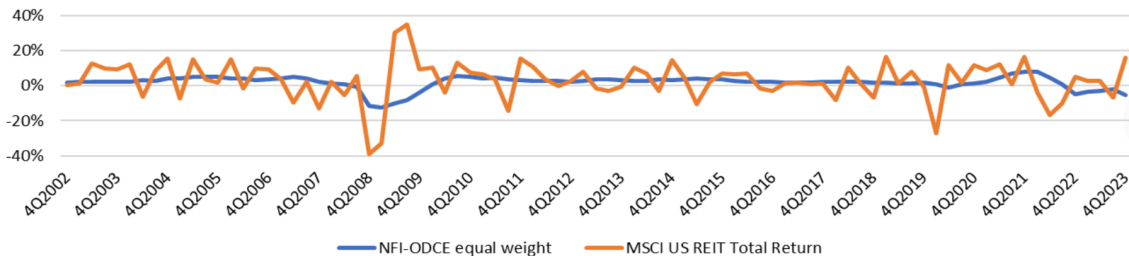
Because of their structural and tactical differences, core private real estate and publicly traded REITs have historically tended to perform differently over full market cycles, creating different potential benefits when added to an investment portfolio. Core private real estate typically has offered steadier performance attributes, with generally stronger risk-adjusted return characteristics, while REITs have offered stronger long-term returns, albeit with greater volatility. This is illustrated in Exhibit 4, which shows the long-term total returns of both segments and the paths to get there.

EXHIBIT 4: BUILDING A BETTER BALANCE OF TOTAL RETURN AND PERFORMANCE STABILITY

A focus on total return over a long-time horizon favors REITs: Balance on \$1 invested



A focus on stability favors a private real estate allocation:
Quarterly returns



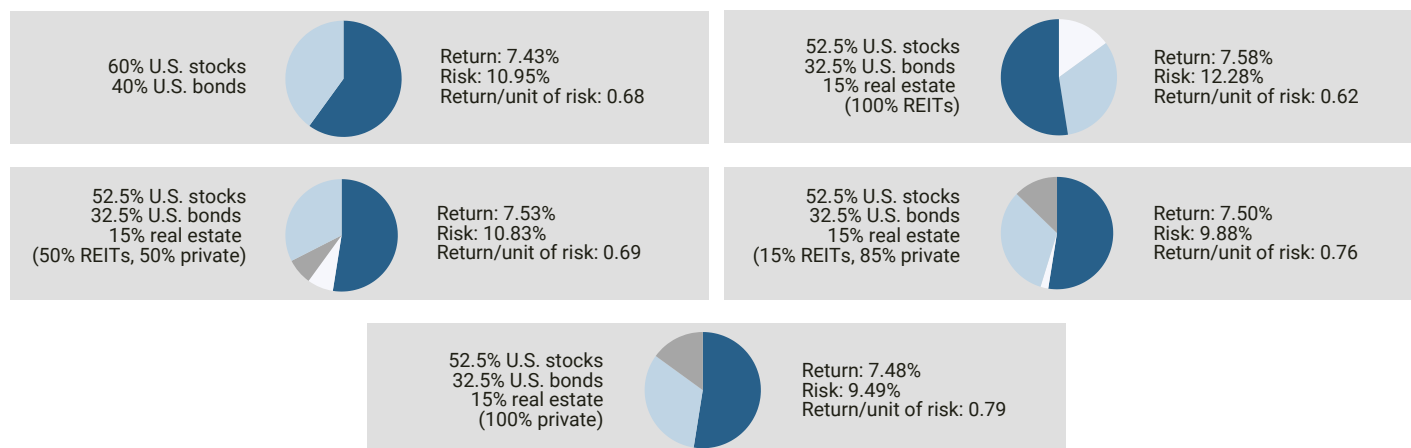
Enhanced risk/reward potential when added to a diversified portfolio

With all of this in mind, it is easy to understand why the growing trend across DC-focused investment managers, particularly in the large plan segment, has been toward building broader real estate allocations that include both core private assets and public securities.

Exhibit 5 demonstrates the long-term risk/reward characteristics of adding various combinations of core private real estate and REIT assets to a 60/40 portfolio over the past 20 years. The big takeaway is that adding a 15% REIT allocation notably increased annualized returns but also risk exposure compared to the 60/40 portfolio. Adding core private real estate into this mix helped to scale back this risk exposure to lower levels than the 60/40 portfolio, while maintaining an attractive return advantage over what was delivered with considerably stronger return per unit of risk.

EXHIBIT 5: ADDING A REAL ESTATE MIX FOCUSED ON CORE PRIVATE ASSETS NOTABLY ENHANCED RISK/RETURN EXPOSURES

Hypothetical portfolio allocations, December 31, 2023 – December 31 2023



CONCLUSION: BETTER TOGETHER

In our view, DC participants deserve access to the full potential of the real estate markets. This includes both private real estate and publicly traded REITs working together as integral components of a well-diversified investment portfolio, alongside traditional asset classes such as stocks, bonds and cash.

Including both core private real estate and REIT allocations appears to offer compelling additive investment attributes that enhance overall portfolio return potential with lower expected volatility when included as part of a multi-asset investment strategy, such as TDFs. This approach also helps to make it easy for participants to access these diversifying characteristics through existing plan investments that they are already familiar with and investing in, rather than requiring action to invest in a new standalone offering. Additionally, many of these multi-asset solutions already have a place for real estate allocations, making the evolution to add diversifying core private assets relatively straightforward.

The history of the DC industry is one of continual improvement and advancement, searching for and introducing new ways to help position participants for the greatest retirement success possible. The current expansion in DC real estate allocations simply represents another step in this process.