

DC Advancements in Real Estate Investing

Three reasons why plans are rethinking real estate allocations to help strengthen participant outcomes

KEY TAKEAWAYS

- Defined contribution (DC) plans are increasingly considering adding core private real estate to their professionally managed target date funds (TDFs) and white label funds to help strengthen participant retirement outcome potential.
- The investment case for doing so is compelling: stronger diversification, stabilizing return profile, enhanced downside protection and inflation risk mitigation without increasing volatility.
- Solutions that blend the complementary investment characteristics of core private real estate with publicly traded REITs more effectively address DC plan needs.
- Today, sophisticated real estate solutions that offer private market benefits and daily liquidity have become increasingly accessible to DC plans of all sizes.
- Professionally managed investment strategies, such as TDFs and white label funds, offer a practical way to deliver the potential benefits of core private real estate strategies to participants, with additional oversight on liquidity management as part of a larger investment portfolio.

"There is a philosophical disconnect between what is offered to DB vs DC participants. On the DB side, we use private real estate, private equity and absolute return strategies, but not on the DC side. As a participant in both our DB and DC plans, it makes no sense that I personally have implicit exposure to alternative assets in the DB plan but cannot access the very same exposures on the DC side."

-Marco Merz, CFA, Managing Director and Head of Defined Contribution at University of California

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

Private and public real estate have long been utilized by defined benefit (DB) plans to help improve long-term investment outcomes. DC plans have been slower to include allocations to private real estate, but that trend appears to be changing.

The strategic rationale for adding a core private real estate allocation into DC participant portfolios is both straightforward and compelling—low correlations with traditional asset classes, stable return profile to help support downside protection, historically strong long-term risk-adjusted returns and potential for inflation risk mitigation without increasing volatility. When integrated into a professionally managed, well-diversified DC investment solution, these additive attributes can help strengthen participant outcome potential through a broader array of market cycles, including periods when traditional asset classes are pressured. Adding core private real estate, in particular, has been beneficial for expanding portfolio return opportunities while decreasing overall volatility and downside risk. This exposure can help strengthen potential outcomes, positioning more participants to reach their retirement goals and higher account balances through improved expected risk-adjusted performance.

Additionally, private and public real estate (the latter typically achieved through publicly traded real estate investment trusts, or REITs) historically have exhibited distinct risk/return profiles, which allow them to play different roles in portfolio construction. The benefits are complementary, and it is a blended allocation of private real estate and REITs that appears well-suited to address DC plan goals and needs.

With this in mind, this paper presents three reasons why DC plan sponsors are rethinking their approach to real estate allocations as they seek to position participants for greater retirement investment success.

ADDITIVE INVESTMENT CHARACTERISTICS

Real estate assets combine characteristics of both stock and fixed income investments, while also offering unique real asset attributes, such as the potential for defensive inflationary benefits and a low correlation to traditional asset classes. These characteristics can offer important potential benefits to retirement portfolios.

Stronger portfolio diversification: Real estate assets historically have exhibited low to negative correlations to traditional stock and bond asset classes. From a diversification perspective, this can help smooth portfolio volatility and increase risk-adjusted return potential across a broader range of investment cycles.

Attractive, stable return profile:

Real estate investments seek to generate recurring cashflows from rent or lease payments, which can offer a source of durable, predictable income. From 1978 through end of 2022, the historical long-term income return for private real estate has been approximately 5.82%,¹ annualized, which has provided a stabilizing return stream through both strong and challenging markets. In addition, underlying properties can appreciate in value. Both of these components have helped the asset class deliver attractive long-term investment returns.

Enhanced downside protection:

Given this appealing combination of low correlations and stabilizing income, real estate historically has helped reduce downside risk exposure when used as part of a multi-asset portfolio, particularly during periods when stock and bond assets have underperformed, such as 2022 when both stock and bond markets delivered negative annual returns while core private real estate remained positive.

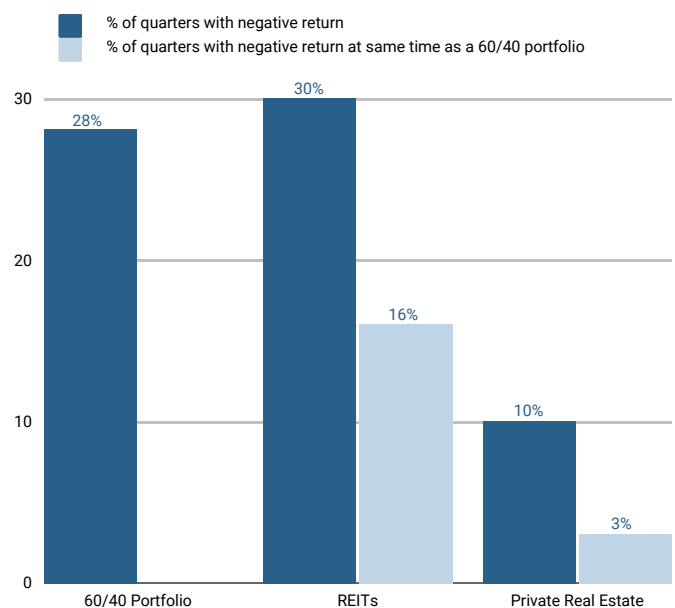
Exhibit 1 shows that, since 2002, a traditional 60% equity/40% bond (60/40) portfolio has generated negative quarterly performance 28% of the time.

During these periods, private real estate assets and REITs have delivered positive returns 90% and 70% of the time, respectively.

Most importantly, private real estate and REITs only delivered negative returns at the same time as a 60% equity/40% bond (60/40) portfolio in only 3% and 16% of the quarters, respectively. This type of added downside protection during traditional stock and bond market drawdowns can help support overall portfolio value preservation, which in turn can help increase investment compounding potential over time, supporting stronger long-term outcomes.

EXHIBIT 1: REAL ESTATE ASSETS HAVE GENERALLY DELIVERED POSITIVE RETURNS WHEN 60/40 ALLOCATIONS HAVE DECLINED

Frequency of negative quarterly returns, January 1, 2003 – December 31, 2022



¹ NCREIF Fund Index - Open End Diversified Core Equity; net of fees

THE THIRD LARGEST ASSET CLASS IN THE U.S.

While real estate is usually classified as an alternative asset, it is also one of the largest asset classes available to investors. U.S. commercial real estate assets are only behind U.S. stocks and U.S. bonds in terms of overall market size.

U.S. market investment universe, in trillions, as of June 30, 2021



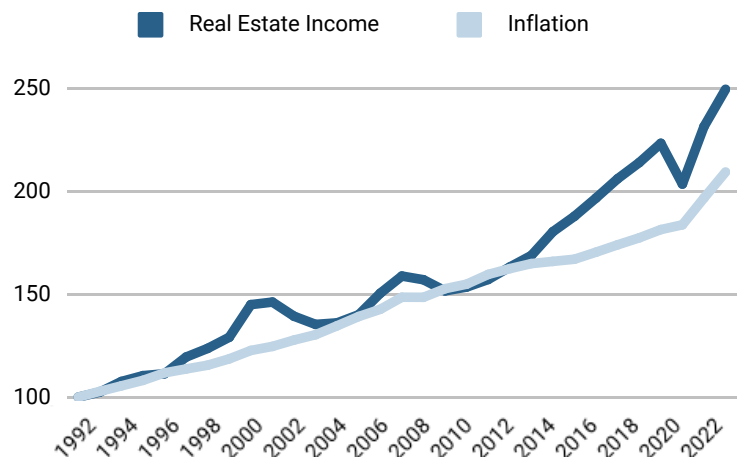
Commercial real estate represents a meaningful piece of the investment universe in the U.S.

Source: Federal Reserve, Bureau of Economic Analysis, NAREIT, SIFMA, World Bank, Economy.com. Based on data through 2021.

Inflation risk mitigation: Rents also have tended to increase over time. This steady income growth has historically contributed to real estate's strong, stable total returns over the long term, which has helped further protect real returns and mitigate inflation risk. This is demonstrated in Exhibit 2, which shows that real estate income has generally outpaced inflation over longer time periods, across both high inflationary periods and more normalized environments.

EXHIBIT 2: REAL ESTATE INCOME HAS CONSISTENTLY OUTPACED INFLATION OVER THE LONG TERM

Annual performance over CPI inflation, December 31, 1992 – December 31, 2022



ACCESS TO BENEFITS OFFERED BY BLENDED EXPOSURE

When it comes to professionally managed, multi-asset portfolio solutions, such as TDFs, most DC plans have relied on REITs to add real estate exposure. By 2021, 61% of TDFs used in the U.S. now have a dedicated REIT sleeve within their asset allocation.² There has also been a significant increase in the number of plans including private/direct real estate assets as an inflation-sensitive allocation in their custom TDFs, rising to 23% in 2021 up from just 3% in 2017.³

With the goal of strengthening participant outcomes, the primary inclusion of real estate should focus on diversification, income, inflation risk reduction and downside protection to help reduce overall portfolio volatility and strengthen long-term risk-adjusted returns.

² Morningstar Direct data 2005 – 2021

³ DCIIA Retirement Research Center 2022 Custom Target Date Fund (cTDF) Study

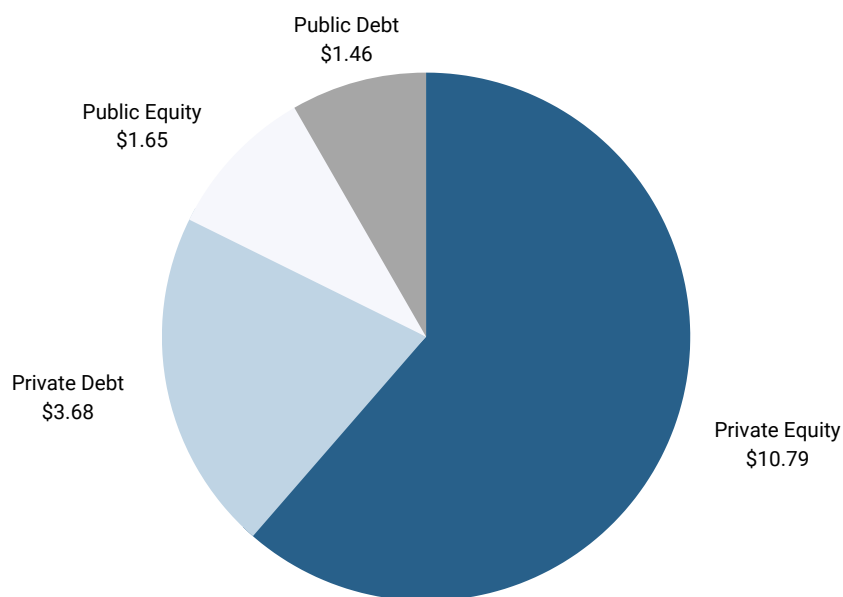
History has shown that these goals can be well met by utilizing blended exposure to core private real estate assets and REITs.

This combined approach can help investors realize the additive benefits of the asset class. Core private real estate strategies typically offer more direct exposure to the bricks-and-mortar characteristics of the asset class, with steadier income and return potential, less volatility, greater inflation defense and lower correlations to traditional assets. REITs generally provide greater liquidity but are usually more influenced by directional stock market trends over short term periods.

Incorporating both private real estate and REITs into a portfolio strategy provides access to the broader investable commercial real estate market. In total, real estate represents approximately \$17.58 trillion in investable assets, of which more than 60% are private equity assets and just over 9% are public equity assets (see Exhibit 3).

EXHIBIT 3: COMMERCIAL REAL ESTATE REMAINS PRIMARILY PRIVATELY OWNED

U.S. commercial real estate segments, in trillions, as of December 31, 2021

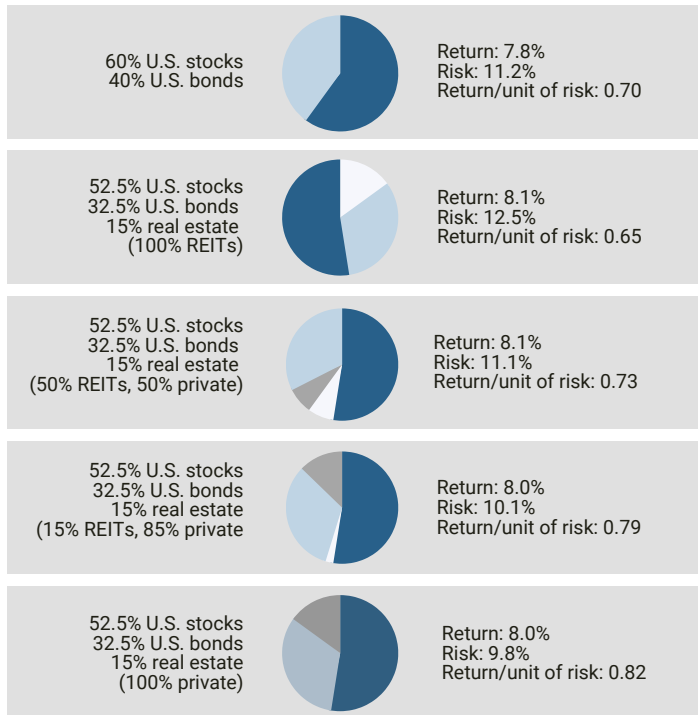


Source: Federal Reserve, NAREIT, CoStar.

Indeed, the trend across investment managers working with DC plans has been toward building broader real estate allocations that include both private assets and public securities, more in line with those found in DB plan allocations. The potential benefits of this approach are demonstrated in Exhibit 4, which shows 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. Including a 15% allocation of either type of real estate asset improved returns and lowered risk. However, risk exposure consistently declined and return per unit of risk notably strengthened as exposure to core private real estate assets increased.

EXHIBIT 4: ADDING A REAL ESTATE MIX FOCUSED ON CORE PRIVATE ASSETS OFFERED NOTABLE GAINS IN RISK/RETURN EXPOSURES

Hypothetical portfolio allocations, December 31, 2002 – December 31 2022



STREAMLINED ACCESS FOR PARTICIPANTS

We believe adding a core private real estate allocation to DC retirement portfolios is most optimal through professionally managed multi-asset class TDFs and white label funds. In these types of vehicles, core private real estate can be held for its specific benefits and potential liquidity needs can be satisfied by the portfolio's traditional asset class allocations.

Additionally, this approach keeps it easy for participants to tap into the potential benefits of real estate investing while providing liquidity management at the multi-asset portfolio level, without requiring additional action on their part. For example, 32% of plans offer standalone REIT strategies⁴ but with very low participant adoption rates, capturing 0.4% of overall DC assets.⁵

TYPES OF REAL ESTATE INVESTMENTS

As an asset class, real estate covers a broad range of property types (sectors), investable securities, investment structures and risk/return strategy styles.

- **Investable securities:** Real estate assets broadly fall into four types of investable securities: private equity, which involves direct ownership; publicly traded equity, which represents indirect ownership; private debt, which covers direct mortgage lending; and publicly traded debt.
- **Investment strategies:** Professionally managed real estate strategies can focus on investing in private equity or debt, public equity or debt, or some combination of these assets, depending on the specific portfolio guidelines. Public equity strategies tend to hold focus on REITs, companies that own and typically operate income-generating real estate or related assets that are traded as equity shares. The private real estate market is 10 times larger than the public REIT market (see Exhibit 3) and offers direct access to the diversification and income characteristics of the underlying brick-and-mortar properties.

Historically, most professionally managed multi-asset portfolio solutions have invested in commercial real estate assets through lower-risk core strategies due to their specific diversifying and stabilizing benefits. Such strategies usually focus on higher quality retail, office, industrial and apartment properties, although some may potentially include areas such as single family rental homes and medical office buildings as part of a larger, well-diversified portfolio.

⁴ Source: PSCA 64th annual survey 2022.

⁵ Source: <https://www.callan.com/dc-index/>.

Fortunately, advancements in technology and plan design, a maturation of DC-focused real estate vehicles and growing demand have supported access to core private real estate assets and REITs via blended solutions or pure play strategies.

CONCLUSION

Many institutional investors consider both private and public real estate as integral components of a well-diversified investment portfolio, alongside traditional asset classes (i.e., stocks, bonds and cash). Yet, private real estate often remains underrepresented in DC participant portfolios, despite its compelling additive investment attributes as part of a multi-asset investment strategy.

In our view, DC participants deserve access to the full potential of the real estate markets, including private investments. The good news is that a growing number of plan sponsors are evolving their approach to real estate investing as they continue to look for strategies to help strengthen participant outcomes. In particular, more are recognizing the need for enhanced diversification, stable income yields, greater downside protection and effective inflation mitigation—all proven long-term benefits associated with core private real estate investing. See the FAQ page at the conclusion of this paper for additional information.

Overall, we see this as an exciting opportunity for plan sponsors who want to expand participant investment potential by accessing strategies that incorporate less liquid private investment alternatives, particularly private real estate. The history of the DC market is one of continual advancements, and adding broader, more-efficient real estate exposures to plans' professionally managed multi-asset solutions offers an additional innovation designed to help position participants on a more secure retirement savings path.

PLAN SPONSORS CONSIDERING ADDING A PRIVATE REAL ESTATE ALLOCATION - FREQUENTLY ASKED QUESTIONS

What are the fiduciary considerations?

These are the same as any other strategy under evaluation for the plan. Would the allocation help to improve participant outcomes? Is there a well-documented selection and review process?

What to look for in a manager?

The key evaluation considerations are also similar to any other strategy selection—experience, investment team tenure and stability, research capabilities and proven track record across a broad array of investment climates and full market cycles. Additional points to consider, specific to private asset investing, include market access and valuation process.

How to consider the impact of fees?

It is important to view fees within the context of overall net performance and potential benefits of the asset class. Historically, a modest allocation to core private real estate asset has been shown to add notable investment value in terms of long-term risk-adjusted performance.

Is liquidity a concern?

Most real estate solutions tailored for the DC market are open-end structures that implement lower-risk core strategies. Liquidity considerations may also be eased given the relatively small allocation within a larger, multi-asset portfolio consisting of highly liquid assets. Additionally, a primary benefit of including a REIT allocation within a real estate strategy at the portfolio level is to help provide a liquidity buffer, as well as diversify sector exposure and return potential.

How can an allocation fit within a broader portfolio?

This depends on the plan, its goals and its participant demographics, in addition to the expected role of the strategy and where it is being implemented in the glidepath/fund. Generally speaking, an allocation of anywhere from 5% to 20% is typical for most DC plans.⁶

Additional Considerations?

Plan sponsors should also consider another key advantage of TDFs and white label funds is the ability to invest in asset classes with additive risk/return profiles that may not be as accessible or suitable for participants as a standalone investment option. Given this, we believe a core private real estate strategy can be a natural fit for these outcome-oriented retirement portfolios.

⁶ Source: J.P. Morgan Asset Management.