Private Market Insights

A NEWSLETTER BY FAST

Public Real Estate Returns Are Down, While Private Real Estate Returns Are Up. Which Is Right?

Co-authors:
Carlin Calcaterra, Principal, Financial Advisor Solutions Team
Brendan McCurdy, Managing Director, Financial Advisor Solutions Team

At Ares Wealth Management Solutions, we continue to receive inquiries from financial advisors regarding the forward prospects for private real estate given the recent decline in public real estate. We believe the most useful way to help advisors grapple with these questions is to point to historical data. Thankfully, we have data on both private and public real estate returns going back to March of 1978, and while no one can predict the markets, we believe the powerful benefits that private real estate can bring to a portfolio should persist through this cycle.

First, the basics—

Since 1978, public real estate has delivered approximately thirty percent higher annualized returns than private real estate. However, this can be largely attributed to the use of three times more leverage in public real estate than in private real estate, and as result, public real estate has experienced three times the volatility. Private real estate, by comparison, has provided much better risk-adjusted returns.[1]

Source: Bloomberg. All data from March 31, 1978, through September 30, 2022. Public real estate measured by the FTSE NAREIT All Equity real estate Index, which is a free-float adjusted, market capitalization-weighted index of publicly traded US real estate equity. Private real estate measured by the NFI-ODCE Value Weighted Index. The NFI-ODCE index is a capitalization-weighted, net of fees, time-weighted return index with an inception date of December 31, 1977, which represents various private real estate funds. Sharpe ratio is a measure of risk-adjusted returns and has been calculated using a risk-free rate of 2%.

	Public real estate	Private real estate
Return	11.5%	8.8%
Volatility	17.9%	5.3%
Sharpe ratio	0.53	1.30
Correlation	0.11	

Correlation

The low correlation of private real estate to public real estate, we believe, is particularly notable.

Seeing the low 0.11 correlation figure, one of the natural questions that our financial advisor clients follow with is, “But is private real estate just public real estate on a lag?”

To investigate whether the 0.11 correlation with public real estate is just a trick of lagged time, we run the correlation of private and public real estate after applying varying lag lengths.

We find that the correlation ticks up mildly over time while remaining low. So, historically, any lagged effect of public real estate onto private real estate has been tempered.

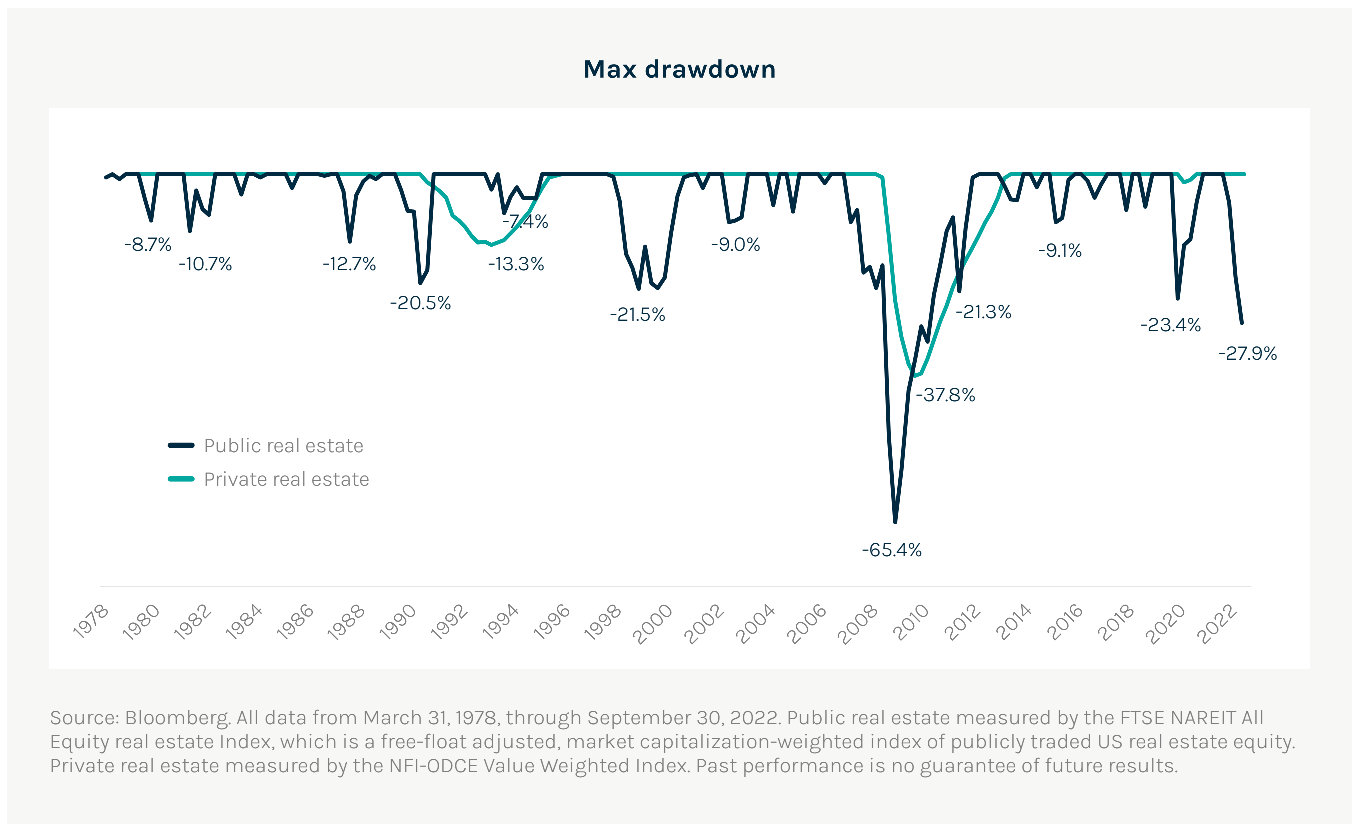
40+ years of private real estate correlation to public real estate with a:	
3-month lag	0.23
6-month lag	0.28
9-month lag	0.28
12-month lag	0.28
15-month lag	0.19

Source: Bloomberg. All data from March 31, 1978, through September 30, 2022. Public real estate measured by the FTSE NAREIT All Equity real estate Index, which is a free-float adjusted, market capitalization-weighted index of publicly traded US real estate equity. Private real estate measured by the NFI-ODCE Value Weighted Index.

Drawdowns

During historical periods of drawdowns in public real estate since 1978, investors in private real estate had a noticeably different experience:

- Two-thirds of the time, private real estate had no drawdown at all when public real estate was in drawdown.
- On the three occasions when private real estate did experience a drawdown, they came at a nine- to twelve-month lag on average.
- Over the past 40-plus years, private real estate drawdowns were meaningfully shallower and shorter-lived than public real estate drawdowns.



Source: Bloomberg. All data from March 31, 1978, through September 30, 2022. Public real estate measured by the FTSE NAREIT All Equity real estate Index, which is a free-float adjusted, market capitalization-weighted index of publicly traded US real estate equity. Private real estate measured by the NFI-ODCE Value Weighted Index. Past performance is no guarantee of future results.

It turns out that private real estate has rarely followed public real estate into its frequent drawdowns—drawing down only three times since 1978 versus twenty-five times for public real estate over the same period. On those occasions when private real estate did draw down, it only moderately followed public real estate, and did so by a lag of nine months, on average.

In fact, there have only ever been two meaningful private real estate drawdowns of more than two percent: one during the early 1990s recession following the savings and loan crisis and the other during the global financial crisis of 2007–2009. These extreme real estate sell-offs were driven by over-building and over-leverage. These forces caused lending to dry up, at which point the private real estate market eventually capitulated, though less than the public real estate market did.

To obtain more specific conclusions about the maximum drawdowns in the real estate market, we investigated the seven largest public real estate drawdowns over the past four-and-a-half decades to determine how exactly, if at all, private real estate drawdowns were related.

	Public real estate			Private real estate					
	Largest drawdown period	Length in qtrs	Max drawdown	Largest drawdown period	Length in qtrs	Max drawdown	Beginning drawdown lag (qtrs)	Max drawdown lag (qtrs)	Recovery lag (qtrs)
1.	6/30/2007 - 6/30/2012	20	-65.4%	9/30/2008 - 9/30/2013	20	-37.8%	5	3	5
2.	3/31/2022 - Ongoing	–	-27.9%	None so far	–	–	–	–	–
3.	3/31/2020 - 3/31/2021	4	-23.4%	6/30/2020 - 12/31/2020	2	-1.6%	1	1	-1
4.	3/31/1998 - 12/31/2001	15	-21.5%	None	0	0.0%	–	–	–
5.	12/31/1989 - 3/31/1991	5	-20.5%	12/31/1990 - 3/31/1996	21	-13.3%	4	11	3
6.	9/30/1987 - 3/31/1989	6	-12.7%	None	0	0.0%	–	–	–
7.	9/30/1981 - 9/30/1982	4	-10.7%	None	0	0.0%	–	–	–
	Average	**9**	**-26.03%**	**–**	**7.2**	**-8.79%**	**3.33**	**5**	**2.3**

Ranked by public real estate max drawdown.

Source: Bloomberg. All data from March 31, 1978, through September 30, 2022. Public real estate measured by the FTSE NAREIT All Equity real estate Index, which is a free-float adjusted, market capitalization-weighted index of publicly traded US real estate equity. Private real estate measured by the NFI-ODCE Value Weighted Index.

History suggests that most public real estate sell-offs have been driven by macroeconomic worries and investor sentiment rather than by real estate fundamentals. This is supported by the fact that public real estate net asset values (NAVs) have tended to hold steady (like private real estate NAVs), even while the equity trades off due to market moves.[2]

Conclusion

As it turns out, conflicting public and private real estate returns, as seen in the present environment, have always been the normal situation, and it is not a matter of one being "right" and the other "wrong."

At Ares Wealth Management Solutions, we believe that both public and private real estate can play important, albeit very different, roles in individual investors' portfolios, and that advisors should consider utilizing these tools to help achieve their clients' overall financial objectives. That said, historical data indicates that these two investment asset classes should not be conflated, nor should public real estate be viewed as a leading indicator for private real estate.

We find that historically, only during the drawdowns of the Global Financial Crisis and the early 1990s real estate correction (resulting from recession and the Savings and Loan Crisis) did private real estate get deeply pulled into the malaise of public real estate.

What each of those events had in common is that they followed a crisis in lending, leverage and over-building. We find none of these forces present in the current cycle.

In 2022, private real estate was not pulled into the drawdown experienced by public real estate, nor was it during the steep drawdown of COVID-19 or the long (four-year) public real estate drawdown of the early 2000s when the dot-com bubble burst.[3]

Thus, the question an investor should ask is this: Looking forward, do you believe that the world is about to head into one of those over-built and over-levered real estate sell-offs?

At this time, we do not believe underweighting would be a prudent action. Because private real estate has historically delivered positive returns in nine of ten quarters, through many market cycles, we believe the investment thesis for a full, long-term (typically dollar-cost-averaged) allocation remains intact.[3]

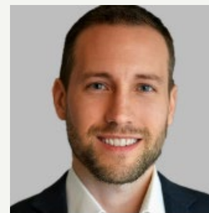
About the Financial Advisor Solutions Team (FAST)

FAST offers resources and one-on-one support to help navigate the complexities of private markets investing. The team's goal is to empower investors to confidently incorporate private markets investments into portfolios. The educational content, research and analytics that FAST delivers are designed to enhance the understanding of the benefits of private markets investments. FAST is a skilled and knowledgeable team of professionals who can answer questions and foster more informed decisions.

AWMS Financial Advisor Solutions Team

Carlin Calcaterra

PRINCIPAL
Financial Advisor
Solutions Team



Brendan McCurdy

MANAGING DIRECTOR
Financial Advisor
Solutions Team

IMPORTANT INFORMATION:

Sources: All data from March 31, 1978, through September 30, 2022. Public REITs are measured by the FTSE NAREIT All Equity REITs Index, which is a free-float adjusted, market capitalization-weighted index of publicly traded US Equity REITs. Private REITs are measured by the NFI-ODCE Value Weighted Index.

1. We believe this difference in volatility is connected to the different ways that private real estate is valued compared with publicly traded real estate. Private real estate is valued based on the book value of the underlying assets, using real estate appraisals, whereas publicly traded real estate is valued based on trading prices determined by willing buyers and sellers of the securities at any given time, which may take into account the book value of the underlying real estate but may also take into account many other factors, such as whether there are more buyers or sellers of the security at any given time, whether stock market investors are more fearful or more confident generally, and whether investors believe management is executing on a good strategy. At any given time, the trading prices of a publicly traded REIT may be higher or lower than the book value of the underlying assets and liabilities. However, appraisal-based valuations of private real estate may be subject to smoothing bias, in which case appraisal-based volatility may be understated. The share prices of AREIT and AIREIT are subject to less volatility compared to public equities because their per share NAV is based on the value of real estate assets they own and is not subject to public market pricing forces. Although their share prices are subject to less volatility compared to public equities, the value of real estate may fluctuate and may be worth less than was initially paid for it. An investment in AREIT or AIREIT is different from a direct investment in private real estate, including with respect to fees and expenses, liquidity and tax treatment. Private real estate is represented by the NFI-ODCE index. The NFI-ODCE is a capitalization-weighted, net of fees, time-weighted return index with an inception date of December 31, 1977, which represents various private real estate funds. Investors cannot invest in this index.

Past performance is not a guarantee of future results.

2. As an example, we took all publicly traded REITs in the Green Street universe with at least 10 years of history (through 9/30/22) and ran the standard deviation of their NAVs (12.8%). That compares to the volatility of the FTSE NAREIT All Equity Index at 16.4%, so volatility of REIT stocks was about 30% higher over that time period than the actual underlying NAV of the REITs.

3. Source: Bloomberg. As of September 30, 2022. Public real estate measured by the FTSE NAREIT All Equity real estate Index, which is a free-float adjusted, market capitalization-weighted index of publicly traded US real estate equity. Private real estate measured by the NFI-ODCE Value Weighted Index.

DISCLAIMER

AccessAres is the thought-leadership and educational division of Ares Wealth Management Solutions. The materials distributed by AccessAres are for informational purposes only and do not constitute investment advice or a recommendation to buy, sell or hold any security, investment strategy or market sector. Ares Wealth Management Solutions is a global brand of Ares Management Corporation.

Not For Use in Ohio.

FORWARD-LOOKING STATEMENTS

This communication includes certain statements that are intended to be deemed "forward-looking statements" within the meaning of, and to be covered by the safe harbor provisions contained in, Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Such forward-looking statements are generally identifiable by the use of the words "may," "will," "should," "expect," "anticipate," "estimate," "believe," "intend," "project," "continue," or other similar words or terms. These statements are based on certain assumptions and analyses made in light of our experience and our perception of historical trends, current conditions, expected future developments and other factors we believe are appropriate. Such statements are subject to a number of assumptions, risks and uncertainties that may cause our actual results, performance or achievements to be materially different from future results, performance or achievements expressed or implied by these forward-looking statements. Readers are cautioned not to place undue reliance on these forward-looking statements. Among the factors that may cause results to vary are the negative impact of increased inflation, rising interest rates, COVID-19, and/or the conflict between Russia and Ukraine on our financial condition and results of operations being more significant than expected, general economic and business (particularly real estate and capital market) conditions being less favorable than expected, the business opportunities that may be presented to and pursued by us, changes in laws or regulations (including changes to laws governing the taxation of real estate investment trusts ("REITs")), risk of acquisitions, availability and creditworthiness of prospective customers, availability of capital (debt and equity), interest rate fluctuations, competition, supply and demand for properties in current and any proposed market areas in which we invest, our customers' ability and willingness to pay rent at current or increased levels, accounting principles, policies and guidelines applicable to REITs, environmental, regulatory and/or safety requirements, customer bankruptcies and defaults, the availability and cost of comprehensive insurance, including coverage for terrorist acts, and other factors, many of which are beyond our control. For a further discussion of these factors and other risk factors that could lead to actual results materially different from those described in the forward-looking statements, see "Risk Factors" under Item 1A of Part 1 of our Annual Report on Form 10-K for the year ended December 31, 2021 and subsequent periodic and current reports filed with the SEC. In addition:

- Interest rates for long-term US treasuries have risen sharply in 2022, after declining for approximately 30 years. If interest rates for long-term US treasuries stay elevated or continue to rise, real estate prices and returns may not perform as well as they did in the prior period of declining interest rates;

- It is possible that private real estate prices will suffer a drawdown similar to that of public real estate in 2022. If private real estate prices suffer such a drawdown, new investors in AREIT or AIREIT may be subject to substantial losses; in addition, because these programs offer limited liquidity through share redemption programs, it may be difficult to sell your shares, especially in an environment of declining real estate prices.

We undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of future events, new information or otherwise.

REF: AM-02352