

10 reasons to consider real estate in your portfolio

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Introduction

Direct real estate is defined as private investments in institutional-quality commercial property. It covers traditional sectors, such as office buildings, apartments, retail malls, and industrial space, as well as structural sectors, which are as diverse as healthcare, student housing and datacentres.

Real estate can provide income potential, with the advantage of adding value through asset management - similar to equity. Regulated and contracted revenues, and long lease terms that deliver predictable return over time, provide a compelling option for investors with regular cash distribution requirements. A growing number of domestic and international investors are turning to real estate to increase diversification, and by making long-term commitments to the sector, they amplify what is a structural, not cyclical, re-allocation of capital.

Why real estate?

The growing realisation of a lower-for-longer global interest rate horizon, coupled with meagre bond and equity returns, have contributed to a secular shift to real assets.

As investors contemplate the implications of political and economic uncertainty on capital markets, it seems a pertinent time to readdress the rationale for real estate in a multi-asset portfolio, and how to optimise performance in an evermore globalised economy.

Against a backdrop of sluggish economic growth, depressed interest rates and market instability, there has been a greater desire for investors to broaden their exposure outside traditional equity and fixed income positions, attracted by the attributes of real assets. For investors reappraising risk and reward, real estate can fulfil a need for stability, diversification, performance, and importantly yield, in a world starved of income. As some economic commentators debate whether a 'return to the old normal' is beyond the reach of Central Banks, we believe one can expect allocations to real estate to continue to increase.

Note: Real estate investments are subject to various risks, including fluctuations in property values, higher expenses or lower income than expected, and potential environmental problems and liability. Please consider all risks carefully prior to investing in any particular strategy. A portfolio's concentration in the real estate sector makes it subject to greater risk and volatility than other portfolios that are more diversified and its value may be substantially affected by economic events in the real estate industry. International investing involves risks, including risks related to foreign currency, limited liquidity particularly where the underlying asset comprises real estate, less government regulation in some jurisdictions, and the possibility of substantial volatility due to adverse political, economic or other developments.

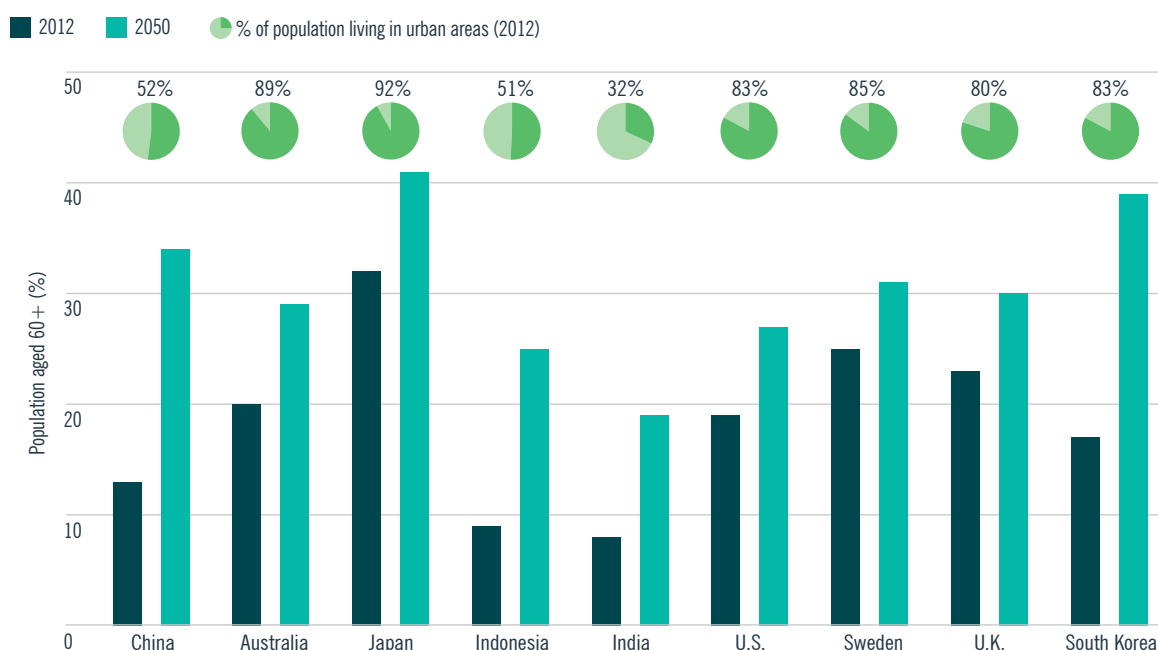
Optimising performance

Higher life and pension fund allocations, the evolution of sovereign wealth funds, legislative change, and socio-demographic developments, all imply an expansion in real estate capital allocations. Institutions in emerging markets are becoming increasingly active in the global market place, with a desire to find less risky alternatives for their expanding pools of domestic savings; and traditionally have high allocations to real estate. In combination, these trends favour an international approach to real estate investment to strive to enhance market return and reduced risk. We believe this investment mantra, borne out of our megatrends research, will drive long-term performance.

Investment strategy must be aligned to evolving global trends as the world's population ages, migrates to cities, embraces technological advancements, and the developing nations grow richer and more influential. Megatrends, by definition, are multi-jurisdictional, but their impacts are local. Incorporating these developments, and understanding how they will impact at a city level, will be critical as real estate capital flows become more concentrated. Embedded within these trends is an appreciation that investor requirements are constantly changing, against a backdrop of challenging market conditions and heightened sustainability pressures.

We believe the key to outperformance will be to identify those cities and industry sectors poised to benefit from ongoing structural change, and apply that insight alongside local expertise to benefit from an early-mover advantage. Long-term investors could enjoy above-average returns, lower-than-average volatility and modest downside risk, when following a city-based real estate strategy that is underpinned by long-term, structural trends. We believe this approach strikes the right balance of risk and diversification, while taking advantage of short-term pricing opportunities.

Fig.1: Global population trends



Source: United Nations, World Bank, 2016

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Income

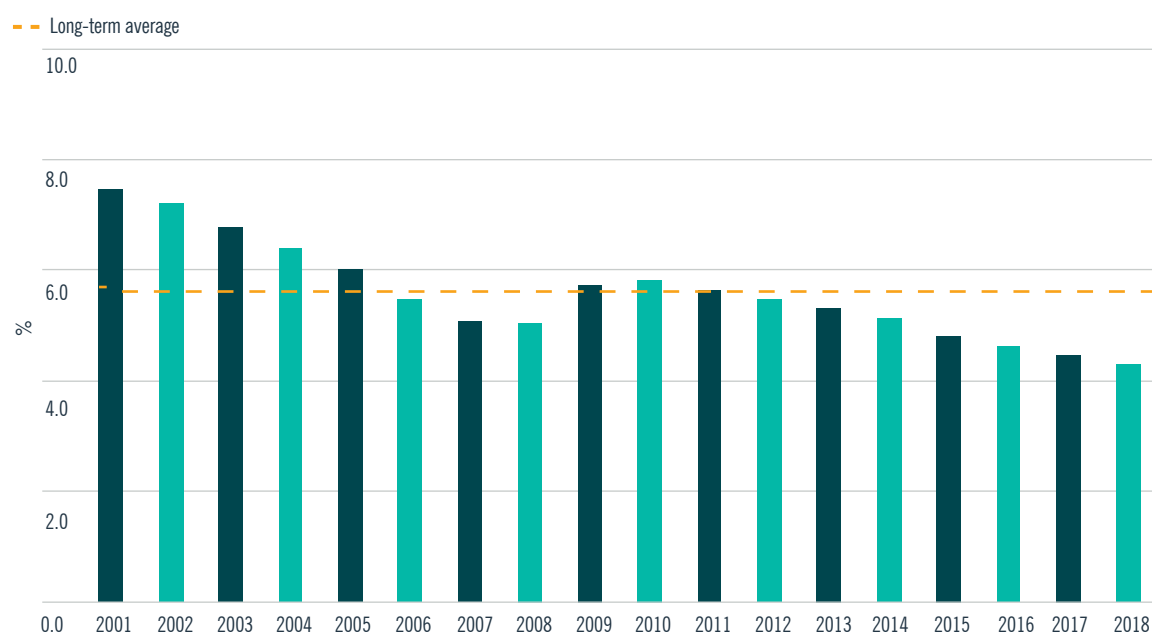
In the current and forecasted muted economic and inflationary environment, resilient levels of rental income underpin the attraction of commercial real estate. Against yields on traditional income-bearing products, such as government bonds, income that is distributed from property is very appealing. Fundamentally, while dividends from equity-based investments are discretionary, rental income from commercial property is contractually agreed, ranging globally from three to 15-year lease terms. This provides income security potential from a range of quality tenants.

2

Volatility management

The income component of real estate may have the effect of tempering volatility. Traditionally, property cycles are less pronounced, with staggered long lease terms helping to mitigate the impact of economic fluctuations on income, which remains fairly consistent even during times of economic distress. Capital appreciation introduces volatility into returns, highlighting the importance of investment timing. History has shown that typically real estate exhibits much greater stability — more akin to bonds than to stocks, or even publicly-traded REITs across most global real estate markets.

Fig.2: Resilience of real estate income returns



Source: MSCI Global Property Index, end-2018

Note: Past performance is no guarantee of future results

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Diversification

Low correlation of real estate returns with those for equities and fixed income products is one of the main arguments for including real estate in a mixed-asset portfolio. Commercial real estate is a longer-term investment with established, lengthy lease terms and sensitivity to seek to development activity, as well as other factors giving commercial real estate a meaningful ability to reduce portfolio volatility through diversification. As property is an intricate part of the economic and social fabric of a city, geographical real estate investment diversification can be captured by structural socio-economic variables.

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Return

Direct or private real estate has historically shown lower levels of volatility than other asset classes, but also superior total returns over the longer term. Given a large component of performance results from its income, annualised returns have historically proven very healthy.

Fig.3: U.S. risk and return, 20 years



Source: MacroBond, NCREIF, end-2018

Note: It is not possible to invest in an index. Performance for indices does not reflect investment fees or transactions costs. The indices in the above chart are U.S. equities: Russell 3000 US index; Non-U.S. equities: MSCI ACWI-ex USA IMI; Direct real estate: NCREIF all property, U.S. REITS: NAREIT all equity REITs index (REITs); U.S. corporate bonds: Bloomberg Barclays U.S. aggregate bond index; U.S. 10-year treasury: Total return from yield (10-year).

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Value-add

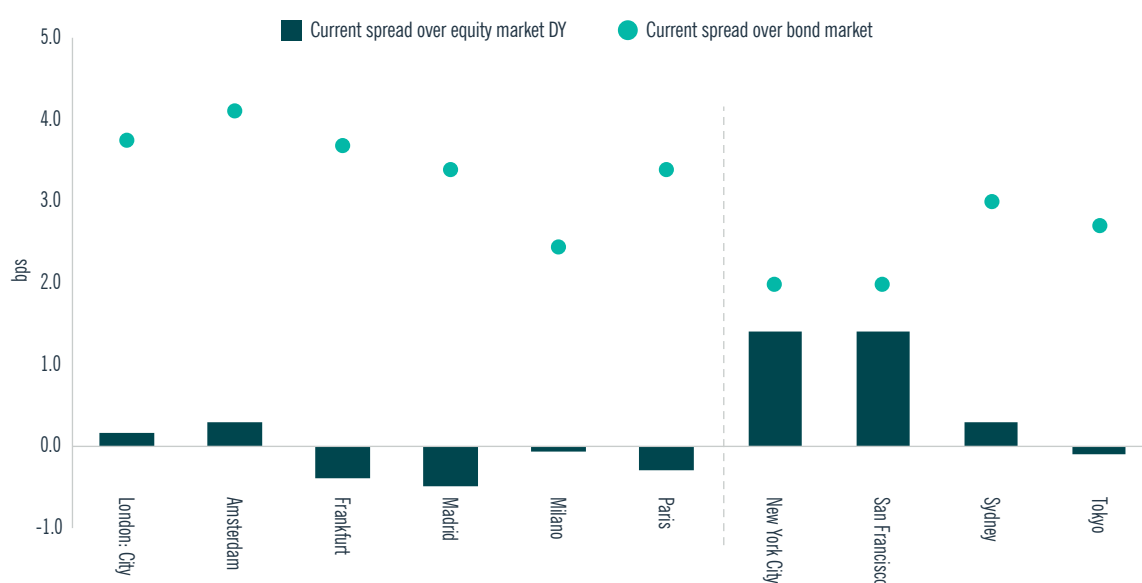
Real estate can provide income potential with the advantage of adding value through asset management. Real estate managers with good market relationships and partnerships with developers, agents, local authorities, private and institutional players, are essential to source attractive value-add opportunities. A sound knowledge of the planning system, coupled with business plans that extend, refurbish, and change the asset use, or improve the property's sustainability credentials, can all unlock and enhance value. An ability to reposition an asset and drive income expansion are defining components in delivering alpha.

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Structural and cyclical

Real estate investment can incorporate short (cyclical) and long-term (structural) market strategies. A tactical, time-sensitive deployment of capital would typically represent a cyclical, possibly contrarian, investor approach, with a goal to achieve enhanced performance. A structural strategy implies a longer-term commitment to a market or sector, and a realisation of a solid, more defensive return profile. Investment strategies, combining both long-term structural trends and shorter-term cyclical opportunities, should continue to enjoy superior risk-adjusted returns.

Fig.4: Real estate office yields, relative to their respective benchmark equity and bond market



Source: Nuveen, MacroBond, Oxford Economics, PMA, August 2019

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Tangible

Real estate is a real asset, with 'hard' credentials, which means it has intrinsic value. The structure has value, as well as the land upon which the asset resides. Well-chosen properties, in locations of long-term value which can benefit from favourable demand and supply dynamics, or infrastructure developments, provide security that some residual value will be retained even if the property or location does not reach its anticipated full potential. In short, the value of a tangible asset can rise and fall, but should not fully disappear.

8

Liability matching

Market cycles are becoming shorter and harder to navigate, and the investment strategies of life, pension and sovereign wealth funds are responding to an expanding world population that is becoming more affluent and living for longer. This has prompted leading investment managers to form real assets groups in response to the structural shift of global portfolios rebalancing to asset classes, such as property, that have the potential to deliver a high income component of return, offer a healthy relative risk-adjusted return, and a clear diversification benefit.

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Inflation protection

The potential for rental income to keep pace with, or outstrip, inflation strengthens the case for real estate as an asset class. Property assets normally feature leases with open market rent reviews, upward-only rent terms, or rental uplifts based upon inflation. Real estate returns are often considered as a potential inflation hedge, notably when inflation has resulted from strengthening economic demand. As prices of goods, services and profits increase in the broader economy, tenant demand and the prices they are willing to pay for space, move in tandem.

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Macro-environment considerations

There will always be headwinds in the real estate industry. To focus solely on the risks, and not the attractive investment opportunities that market volatility can present, would be a mistake. Real estate is multi-dimensional, and investors should consider the versatility of the sector, and the range of markets, deployment strategies and reward opportunities that are ever-present. Given wider global uncertainty and asset volatility, it is no surprise that allocations to global real estate are projected to continue increasing in the future.

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Managing a suite of funds and mandates, across both public and private investments, and spanning both debt and equity across diverse geographies and investment styles, we provide access to every aspect of real estate investing.

With over 80 years of real estate investing experience and more than 550 employees* located across over 25 cities throughout the United States, Europe and Asia Pacific, the platform offers unparalleled geographic reach, which is married with deep sector expertise.

*Includes 287 real estate investment professionals, supported by a further 260+ Nuveen employees
Source: Nuveen, 30 June 2019

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