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SAXUM INSIGHTS

Alternative Assets: Investing in Real Estate Through Alpha Driven Strategies

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Alternatives is a common title utilized to label investments outside of the traditional portfolio of stocks, bonds and cash equivalents. Investments in commodities, private equity, private debt, hedge funds, infrastructure and real estate all fall under the umbrella of alternatives. For this *Saxum Insights*, we will be referring to real estate when discussing alternatives. Currently, 61% of all institutional investors actively invest in real estate which is the highest participation rate across all alternative assets.(1)

To start, we believe it is most prudent to take a top down macro view of the market as a basis to frame a robust discussion on asset allocation into alternatives. Taking a holistic view of the market will establish a foundation to appreciate the idiosyncratic attributes of real estate as an increasingly popular core asset class for both institutional and retail investors.

Market Update & Technicals

Over the last ten years, the resilience and staying power of the market during the post crisis rally has been nothing less than remarkable. Fundamental, technical, idiosyncratic, political and monetary policy driven variables have all been at play, resulting in a sustained positive effect across multiple asset classes.

Consider the following performance and trading statistics since the depths of the crisis:

- S&P 500 is up 272% from the March 9, 2009 lows (666 to 2477) and has registered the second longest bull run of all-time over 3,041 consecutive days(2)
- S&P 500 index is up 9.5% this year with 29 record highs and counting(3)
- S&P 500 registered 109 consecutive days in 2017 without a loss greater than 1% which matched the longest run in 22 years going back to May 1995(4)
- Volatility hit an all-time low vs. the past 20 years as the VIX volatility index closed lower than 10.0 on a total of 11 days, and 7 of those days occurred in 2017 alone(5)

Staying Power

Positive market fundamentals to note going forward:

- Q2 2017 GDP rebounded to 2.6% with a 2017 target of 2.2% vs 1.6% in 2016(6)
- Unemployment rate of 4.3% equates to a 17-year low(7)
- Inflation is stabilizing and holding at 1.5% gauged by the Fed's preferred measure of core Personal Consumption Expenditures ("PCE") despite falling short of the longer run target of 2%(8)
- Largest proposed U.S. tax overhaul in over 30 years since the Reagan era(9)
- Regulation reform remains a core political action item to stoke domestic growth
- U.S. safe haven status along with dollar stability/appreciation due to tightening monetary policy will continue to deliver net positive capital inflows domestically

Risk Factors

Critical risk factors to monitor going forward:

- Tightening monetary policy with divergence between the Fed Board of Governor's Dot forecast (3% YE 2019) and current market pricing (sub 2% by YE 2019)(10)
- Flattening yield curves in a tightening cycle reminiscent of pre-crisis price action 2006-07 with absolute curve levels at the ~10-year lows(11)
- Federal reserve balance sheet run-off anticipated to commence Q4 2017 which marks the true end of quantitative easing and a form of implicit tightening(12)
- S&P 500 forward earnings multiples trading at 18.0x forward earnings which equates to a 15-year high and firmly above the longer-term average of 15.1x(13)
- Politically growth friendly policies are reasonably priced into current valuations
- Global growth challenges in both Europe (Brexit) and Asia (China) and geopolitical challenges in North Korea and Qatar, among others

Outlook

After accounting for risk factors given the current timing of the cycle, we believe the key to investment outperformance over the next 3-5 years will be dependent on an investor's ability to be highly selective in identifying assets with attractive risk-adjusted returns. Our view is that the easy money has been made over the past eight years as indicated with stocks already tripling and close to quadrupaling off the crisis lows. We believe the equity market's risk/reward is not skewed to the upside and prudent investors should be focused on alternative asset allocation strategies to preserve total returns while decreasing correlation to the broader markets. Going forward, alpha strategies will be back in the driver's seat and to use an old investment saying, "it will be a stock picker's market." As a reference, alpha refers to the excess return of an investment relative to the return of a benchmark index representing the market as a whole. This philosophy is no different across asset classes and especially relevant when evaluating across a range of real estate strategies.

Real Estate's Value-Add

Real estate is a hybrid asset which displays characteristics of both bonds and stocks and therefore can perform in variety of market environments. Real estate is also an asset class that is tax efficient, highly leverageable, produces income and provides a hedge against inflation. There are a significant number of factors worth exploring which contribute to the positive idiosyncratic attributes of real estate as a core asset class.

Valuations

While real estate has bounced back from the depths of the crisis, it did lag the large momentum-driven move higher in the equity market. For example, the S&P 500 is up 58% from the immediate pre-crisis highs of 1565 on Oct 2007. For relative comparison, aggregate commercial office real estate was trading at an average of $298 psf at the pre-crisis highs. Current pricing for office is achieving $303 psf which indicates the market is barely outperforming the pre-crisis highs. Commercial retail real estate has experienced similar price performance with a pre-crisis average price of $198 psf vs. current pricing at $201 psf. Another key indicator is that the S&P 500 is currently trading at 18.0x forward earnings which registers a 15-year high and sits aggressively above the long-term average of 15.1x. Therefore, in a gradually rising market, we believe that real estate has more incremental room to run to additional upside vs. the equity market given that real estate is almost unchanged from pre-crisis levels and the equity market is up 58% (*Chart 1*).

Inflation Hedge

Bonds are the most compared asset class to real estate given their similar income producing characteristics. For that reason, there is a popular misconception that real estate's investment performance is considered highly correlated to that of a bond. This conclusion would be a mistake, since capitalization rates are affected by a multitude of factors (capital inflows, supply/demand, local market idiosyncrasies, financing, etc.) with rates representing only one of many inputs.

For example, a traditional bond has a fixed coupon and therefore loses value as rates move higher due to the inverse relationship of bond yields and price. Real estate however does not have a fixed coupon as rental rate increases are negotiated into leases, along with the ability to pass through higher costs through higher rents if the economy heats up. For this reason, real estate behaves more like a stock in higher inflation/growth markets by passing on increased operating expenses and higher rents to tenants (*Chart 2*).

Price Performance Comparison: S&P 500 and Commercial Real Estate Office & Retail

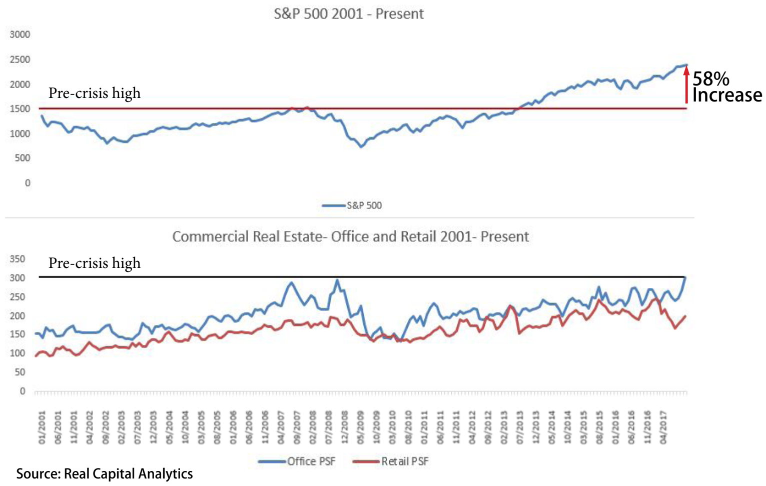


Chart 1

Real Assets Outperform Financial Assets When The Fed Raises Rates

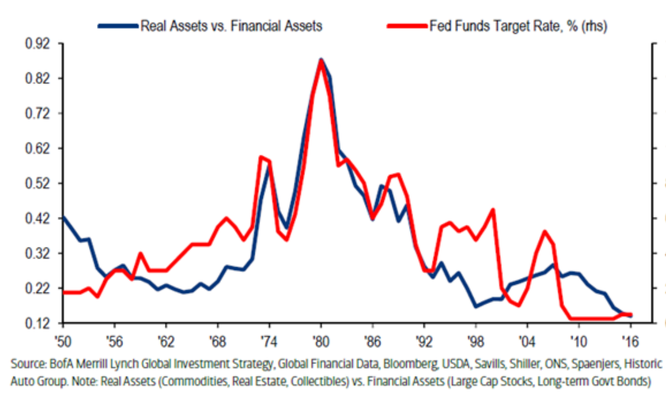


Chart 2

Leverage
CMBS issuance this year is expected to total approximately $75 billion which is comparable to 2016 supply. Over the first two quarters of 2017, CMBS issuance totaled $34.1 billion which is slightly less than it was during the same time last year. For comparison, aggregate levels are still much lower than the peak of the crisis which reached $230 billion in 2007 and $94 billion in the 2004 refi-wave (*Chart 3*).

While multiple conclusions can be drawn, we believe that the recent substantial decline in debt supply may be another positive variable for investing in real estate. Leverage can either be a friend or enemy to an investment and in relation to real estate, increased bank regulation, tighter credit boxes and more stringent underwriting standards have provided a cleaner credit profile which will help avert systemic risk across the entire asset class in a wide spread bear market. In addition, regulatory constraints force banks to be more responsible and cautious in evaluating deals to finance which will directly decrease the likelihood of developers chasing deals to non-economical levels due to cheap credit.

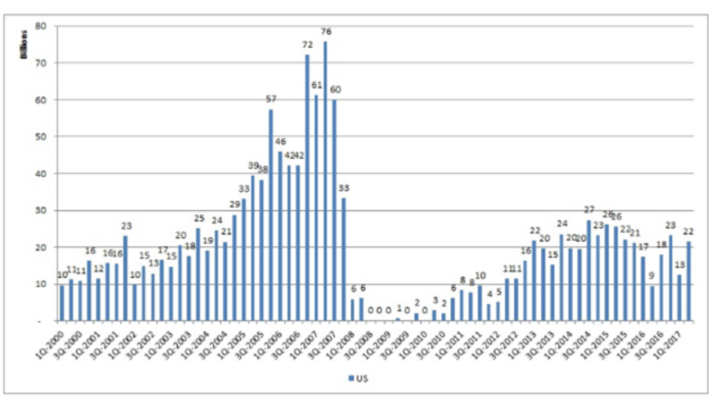
Risk-adjusted returns
Not all yields are created equal as a 10% return in the stock market is a much different risk/return profile than a comparable 10% return in the treasury market as the latter is a much safer asset backed by the U.S. treasury with less volatility. Sharpe ratios are utilized to measure the risk adjusted return of an investment, which account for the underlying volatility of the asset. The calculation is determined by dividing the investment's total return by the implied price volatility of the asset.

Consider the NPI (NCREIF Property Index, Core Real Estate) and the NFI-ODCE (NCREIF Fund Index, Open-End Diversified Core Equity) as two real estate indices to represent as a benchmark for the aggregate asset class.(14) In general, both real estate indices have similar volatility as government and corporate bonds, but returns are more similar to large cap stocks. That inherently means that those real estate indices have higher sharpe ratios and thus better risk adjusted returns than commodities, stocks and bonds (*Chart 4*). A conclusion to draw is real estate provides a similar return with superior defensive downside protection due to the lower implied volatility which will be valuable in the event of a risk off move lower.

Capital Inflows/Positioning
We believe that capital inflows and positioning will be one of the most influential driving forces of real estate performance over years to come. In terms of positioning, at the end of Q1 2017 there was $245 billion of private equity capital on the sidelines that is ear marked for investment in real estate in the U.S.(15) Overseas capital from Europe and Asia continues to find its way into the U.S. real estate market. Reasons are plentiful, however the demand for income producing investments with long U.S. dollar exposure are the dominant fundamental drivers.

Rates overseas are also much lower and in fact negative in some cases, which provides better economics to borrow in the local currencies, convert to dollars and then buy U.S. hard assets. Money is made on the yield differential, but also likely due to a stabilization of the dollar and further long-term strength vs. a majority of countries in both Europe and Asia. The DXY dollar index is up 16.2% over the last three years in total despite a loss of 6.6% year to date, which is due to a combination of domestic political gridlock and the bond market's disbelief in the Fed's future projected path of rate hikes.(16) We believe the recent pull back in the dollar will prove to be short lived as pricing stabilizes followed by incrementally increasing demand for domestic assets going forward which will be a net positive for real estate.

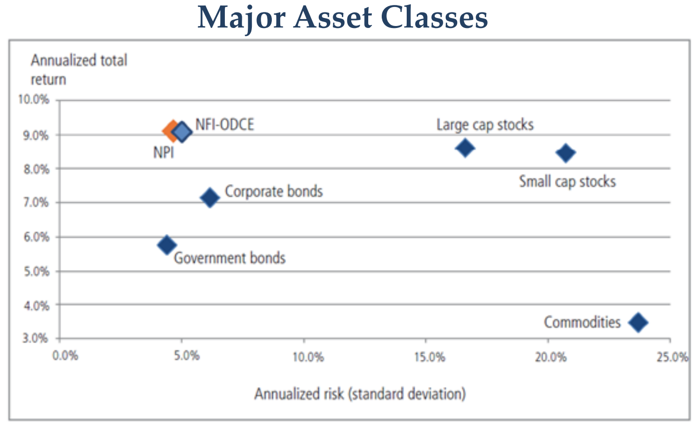
U.S. CMBS Issuance By Quarter



Source: CRE Finance Council, CMBS Issuance

Chart 3

20-Year Risk and Return Profile Across Major Asset Classes



Source: Thomson Reuters Datastream
Data from 1993Q3-2013Q2
The indices used for each asset class are: Government bonds, Bank of America Merrill Lynch Treasury Master; Corporate bonds Baa-rated, Barclays US Aggregate Corporate Intermediate; Core Real Estate, NCREIF Property Index (NPI), NCREIF Fund Index—Open-End Diversified Core Equity (NFI-ODCE); Large capitalization stocks, Russell 1000 index; Small capitalization stocks, Russell 2000 index; Commodities, S&P GSCI Commodity Index. The risk free rate is the 10-year US Treasury note yield.

Chart 4

Conclusion

Not all asset classes and strategies are created equal. We believe that hyper-focused real estate value-add strategies will outperform stocks over the next five years on a total return basis and provide an even larger deviation to the upside when returns are adjusted for implied volatility (sharpe ratio). All of the positive real estate specific attributes previously mentioned will attract incremental interest into the asset class going forward.

There are always profitable deals to be done regardless of the timing of the cycle based on the specific strategy employed along with the execution of the strategy. Given the stage of the current cycle, we believe it's crucial for investors to strategically lighten up exposure to stocks and bonds while increasing exposure in real estate with a specific focus on markets where strong demand and economic drivers provide significant potential for value creation.

Chad DeBolt
Director of Investments

Our Saxum team has a broad range of experiences, and we believe that analyzing real estate through a variety of lenses brings multiple perspectives to focus which fit an asset class that is in itself so inherently complex. No individual real estate deal is the same given the multiple levers that can be pulled throughout numerous stages of an asset's life cycle. Saxum Insights will cover a range of topics from extremely technical and analytical in nature, to simple thought driven concepts based on sentiment and anecdotal observations. Sometimes the most thought-provoking ideas are simple concepts which are misunderstood or overlooked. Feedback and thoughts are always appreciated.

Sources

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(15) *BisNow Private Equity Fund Real Estate Activity*
(16) *Citi Velocity 3.0 Charting Analytical Tool*