SAXUM INSIGHTS

Real Estate: Asset or Liability? A Case for Alternative Investments

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Saxum Real Estate is proud to officially launch a new kind of newsletter. Saxum Insights will cover a broad range of real estate and financial topics, which will prove to be both educational and thought-provoking for industry professionals and investors alike. First up: Real Estate: Asset or Liability? A Case for Alternative Investments.

Our analysis today will provide a discussion on diversification through alternative investments. As true diversification is a complex and nuanced concept, our analysis does not attempt to fully analyze diversification, but rather to provide a crucial observation from a very simple lens. This paper only touches on a few of the many fundamental reasons why alternative investments should be a core holding of an investment portfolio. We will review several of them in more depth in future Saxum Insights.

Real Estate: Asset or Liability? A Case for Alternative Investments

Diversification through asset allocation is the core building block to prudent investment portfolio construction. Diversification not only applies to the net asset value of a portfolio (market value of assets minus liabilities), but it also refers to the net annual cash flow or dividends that a portfolio produces from each asset. Stocks, bonds and cash equivalents are the bread and butter allocations of a traditional portfolio, while alternative assets, such as real estate, have become increasingly popular to both individual investors and institutions alike.

Asset allocation can be viewed in a variety of ways, but we would like to evaluate it to start through a basic lens, the home owner.

Do you consider your primary residence an asset? One step further—do you consider your second or third home to be an asset? If you answered *yes* to either of the above questions, then do you consider those assets as the principal alternative asset/ real estate allocation of your personal investment portfolio? The most popular response we receive from individuals who are challenged with the idea of investing in real estate is that a considerable portion of their net worth consists of their primary residence and vacation homes. Therefore, they count those assets as a significant real estate allocation to their portfolio.

An asset is a vehicle to store something of value. Over time, it should produce consistent positive net income in the form of distributions (coupons/dividends) or price appreciation. However, unless a home is rented to a third-party, those assets are an expense on a short-term basis. Residence related costs account for approximately 34% of total household operating expenses, typically the largest living expense a family faces *(Figure 1)*. Analyzing the itemized expenses of a residence is also eye opening when considering the various costs that arise in addition to the mortgage, taxes, and insurance, which account for approximately 59% of all household expenses *(Figure 2)*.

Family Operating Expenses

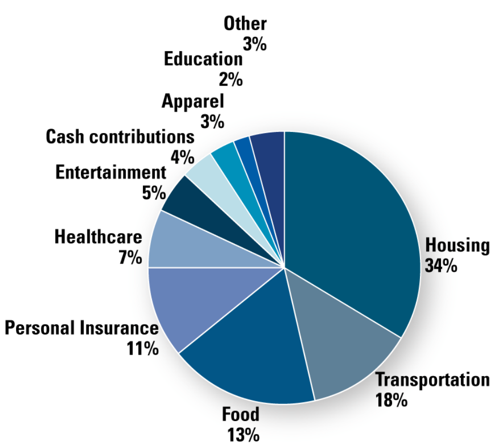

Figure 1

Residence Only Operating Expenses

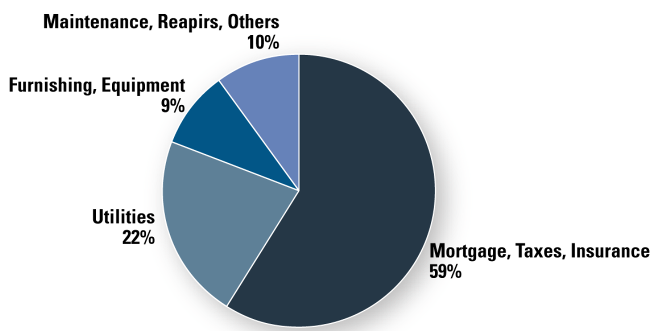

Figure 2

Of course, over longer periods of time and optimistic price appreciation, a homeowner could be compensated through the eventual disposition of their asset. Ultimately, most investors don't look at their home as a short-term trading vehicle to monetize on market fluctuations and instead look at it as a form of shelter for their family and a place to store value as they pay down their principal mortgage over time. Also, storing value in a home is just that, since equity in a residence is dead money not earning an annual cash return. Outside of price appreciation, the only notable source of income from a home residence would be in the form of a vacation rental. Note, a vacation home is considered a second residence and cannot be expensed if used for personal purposes during the tax year for more than the greater of 14 days or 10% of the total days rented at a fair market rate.

Most investors are familiar with the common financial phrase "cash is king." Cash inferred from this phrase can have a variety of meanings. In its purest form, the term cash would include actual cash deposits, along with the percentage of the portfolio allotted to assets that can be liquidated with minimal price volatility. In a simple form, think of a safety net for times of financial distress. We would like to slightly reword this catch phrase to "cash flow diversification is king," to relate more accurately to our diversification thesis.

One of the first visible signs of extreme financial stress in a company is cash flow imbalances. When we think of diversification, we think of personal assets more from an income statement perspective than a balance sheet view. Order of operations in a stress situation are typically as follows for an individual or family: daily survival necessities come first, followed by debt service, non-critical daily costs, and finally, growing reserves or savings for the future. In a normal situation, this equation is positive as revenue from employment and investments outweigh the above listed expenses. However, if cash flow becomes insufficient due to a loss of employment for example, then the next steps include both cutting costs and dipping into savings. The final option would be selling assets outright with liquid assets being the first to go.

Consider the following example when bringing the previously mentioned observations on assets versus liabilities and cash flow diversification together when analyzing a personal residence as an asset.

Assume a family makes $100,000 a year and 100% of that income comes from a single earner working in finance. Since the family's aggregate annual income comes solely from one job, the annual cash flow is 100% correlated to their ability to keep their job, perform, and be compensated. However, if they are laid off in this example with zero alternative income producing assets, then their cash flow goes to zero immediately and the order of financial distress operations mentioned above would be set into motion.

In this example, the family most likely considered their home as an asset in their portfolio mix and thus did not invest in income producing real estate since from their perspective, that bucket was already filled. It is also important to note that at an approximate 94% correlation coefficient, the financial sector is one of the most correlated sectors to the overall beta of the market. Analyzing the correlation of a primary business to the broader market is an important input for personal asset diversification and careers outside finance are generally descending in risk to the broader market.

In the purest form, portfolio diversification and the inherent cash flows associated with it are predominately what matters most in a financial risk situation, when the true colors of perceived assets and liabilities shine through for what they really are in the form of short term cash imbalances.

What is your current portfolio diversification? Your personal finances and family wealth will be the most important company you will ever run; why should they deserve any less attention and importance than a high firing blue chip company?

Our target goal for investors in regards to their personal portfolio diversification is to thoughtfully invest in real estate/alternative investments to achieve an allocation where 25%-35% of their wealth is accounted for outside of their primary occupational earnings and personal residence. The 25%+ allocation is a target that should attempt to align and neutralize the dependency on employment income and traditional investments which is crucial in the journey to financial freedom. This goal will take time to build to, but it's completely achievable with discipline and patience.

It is important to consider that after taxes are paid, it's extremely difficult to achieve income based returns comparable to real estate through investing in traditional investments such stocks and bonds alone. This view is supported by the average dividend yield of the S&P 500 Index at approximately 1.84% over the last 20 years and the total return of the Barclays US Aggregate Bond Index of 2.27% over the last five years. Real estate often targets a minimum hurdle rate of 8%+ cash on cash returns for select assets and strategies. Investing regardless of asset class comes with risk which keeps some investors on the sidelines. However, the counter view is direr in our minds, which would be relying on 100% of annual income generated from one concentrated income stream whether that may be a salary or traditional assets.

The moderate risk portfolio target allocation for real assets according to Charles Schwab is a mere 4%, while stocks and bonds account for 91% *(Figure 3)*. As mentioned above, a traditional portfolio will have a very hard time producing impactful annual income based returns on dividends and coupons alone. Finally, note the large discrepancy in alternative asset allocations as a percentage of the total portfolio of institutional (pros) versus individual retail investors *(Figure 4)*. Maybe they know something that the average investor does not?

Traditional Investor Portfolio

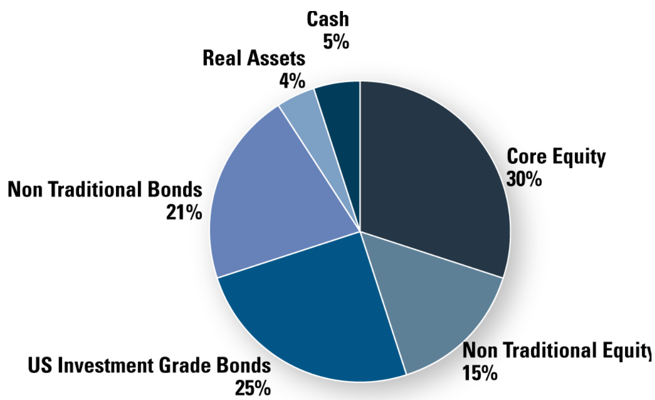

Figure 3

Institutional vs. Individual Portfolios
% Allocated to Alternative Investments

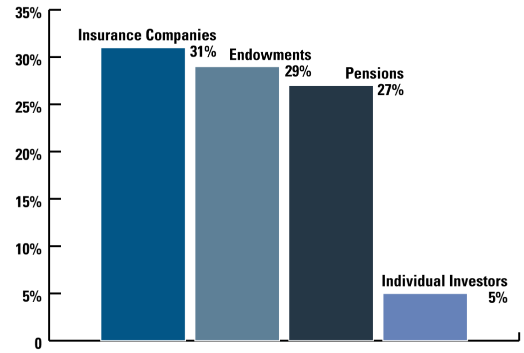

Figure 4

At Saxum, we practice what we preach. Our team invests alongside our investors because not only do we believe in our investment strategies and the assets we acquire, but investing in real estate allows us to achieve portfolio diversification. Diversifying away from paper assets is a structural view of ours, favoring quality, income-producing hard assets in our portfolio long-term. This thought process does not even consider the variety of macro and fundamental reasons for investing in real estate, which will be covered in future *Saxum Insights* (e.g. short dollar, inflation hedge, tax advantages, leverage advantages, utility, tangibility, etc.).

With that said, consider these final two questions: Do you consider your home an asset or liability? Is your income stream diversified?

As always, we respect and appreciate the diverse backgrounds of our investors and fellow industry professionals, so your feedback is welcomed and encouraged.

Chad DeBolt
Director of Investments

Saxum Real Estate is a vertically integrated privately-held real estate investment and development company that serves as owner, operator and developer of all assets in its portfolio. Saxum specializes in creating value through repositioning and developing assets in transit-oriented markets with high growth potential. Saxum builds its success on the ability to identify, acquire and execute unique real estate strategies that maximize asset value. Our team is comprised of highly skilled real estate professionals with extensive experience as investors in real estate. We focus on areas in which we can leverage our superior market knowledge and local relationships in order to identify and create asset value in any economic cycle.

Sources
Figure 1: Bureau of Labor Statistics: Consumer Expenditures 2015
Figure 2: Bureau of Labor Statistics: Consumer Expenditures 2015
Figure 3: Charles Schwab, "A Modern Approach to Asset Allocation and Portfolio Construction," 2014
Total Return Model Portfolio with Moderate Risk
Figure 4: Money Management Institute, "Distribution of Alternatives Investments through Wirehouses," 2015
Global Pension Asset Study 2016
NACUBO 2015 Study 2015
Preqin, "Insurance Companies Investing in Alternative Assets," 2015, Total Alternative Assets Allocation as % of Total Portfolio, Insurance Companies with 5bln or less AUM