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The Value of Private Real Estate in Balanced Portfolios

Real estate investments can play a valuable role in your portfolio, offering potential benefits such as income generation, low volatility, low correlation with other assets in your portfolio and defense against inflation.

Many investors try to time the real estate cycle, but we invest in real estate with a consistent approach—backing expert real estate owner-operators who we believe can successfully navigate through the market's ups and downs.

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Because of the cyclical nature of many real estate markets—and especially due to the recent painful memories of the mortgage crisis—many investors think that the only way to make money in real estate is to "catch a wave"—in other words, to invest in the right place and at the right time.

This sort of thinking may deter investors from long-term real estate investments if they are worried about current market conditions. After all, several key real estate metrics are trending above long-term averages. If you are looking at commercial property values, you may find it concerning that prices have surpassed the peak levels that were achieved prior to the global financial crisis. Or, you may look into multifamily residential supply, only to be scared off by the elevated levels of apartment construction activity in many areas of the U.S.

We believe that focusing solely on current market conditions ignores the true, long-term value that private real estate investments can add to a portfolio. Contrary to the highly publicized booms and busts of some real estate segments, most private real estate investments offer many risk-mitigating benefits to investors, such as low correlation with core asset classes, long-term protection against inflation, income generation and—yes—low volatility over time.

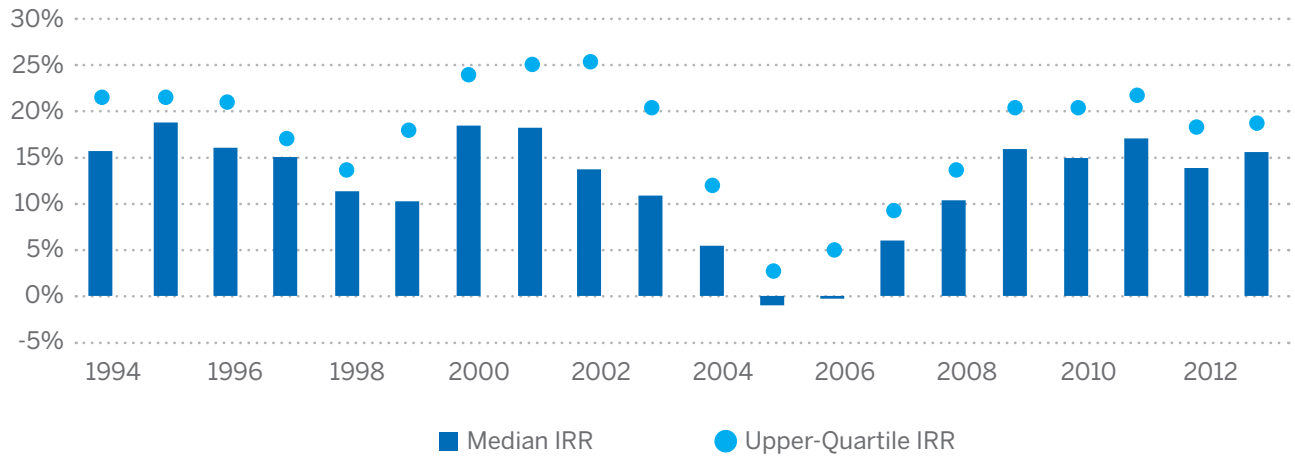
Success in private real estate, in our view, has less to do with trying to time the market and much more to do with consistency. The key is finding top-tier, operationally oriented managers who have shown an ability to thrive throughout the ups and downs of the real estate cycle, and sticking with those managers over time.

Private real estate: A consistent performer

Private real estate funds have performed well in most years since the mid-1990s. The chart below provides since-inception internal rate of return (IRR) data for Cambridge Associates' real estate fund universe by vintage year. Returns across this time span were generally quite attractive, and even median funds from the mid-2000s that weathered the worst of the mortgage crisis managed largely to preserve their limited partners' capital. (Note that funds launched after 2013 are still early in their investment periods; they are excluded from the chart, as their track records are not yet representative.) Additionally, prudent manager selection has made a difference—top-quartile managers outperformed the median manager by an average of more than 5% annually.

There are other reasons besides raw returns that make private real estate specifically attractive for balanced portfolios, as we discuss in the charts on the following pages.

Private Real Estate Fund Returns
(IRR since inception, 1994–2013 vintage years)



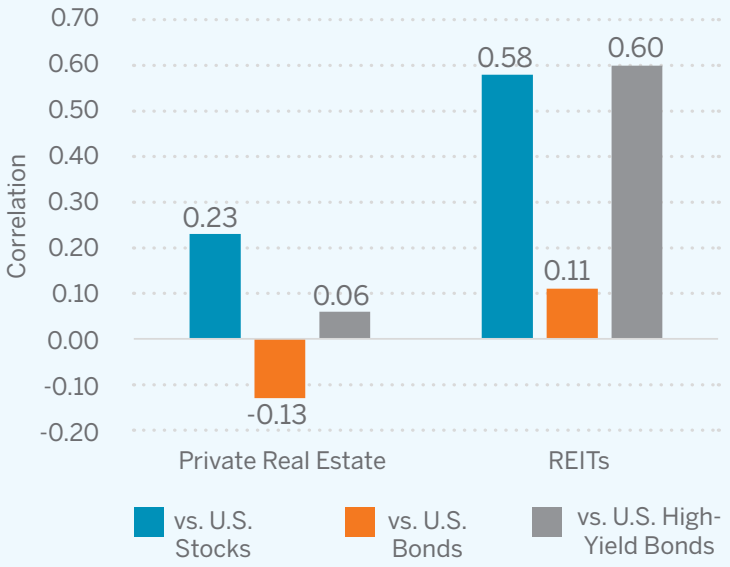
Source: Thomson Reuters. Private real estate returns are represented by the Cambridge Associates Real Estate Index.

Low correlation with other core asset classes

Private real estate historically has produced low correlation with stocks and bonds—even more so than publicly traded real estate investment trusts (REITs). Low correlation means that real estate helps to diversify balanced portfolios.

This lower correlation is driven by several factors. For one, real estate tends to move more in concert with the direction of the economy, while stock prices, for example, tend to move in advance of a change in economic fundamentals. Additionally, private real estate is valued according to periodic property appraisals, while exchange-traded stocks and bonds are revalued by the investing public every second that the markets are open for trading.

Correlation of Private Real Estate and REITs with Other Asset Classes (1/1/1986 - 9/30/2016)



SOURCE: THOMSON REUTERS

Source: Thomson Reuters. Asset classes are represented by the Cambridge Associates Real Estate Index for Private Real Estate Funds, the FTSE NAREIT Index for REITs, the S&P 500 Index for U.S. Stocks and the Bloomberg Barclays Aggregate Bond Index for U.S. Bonds.

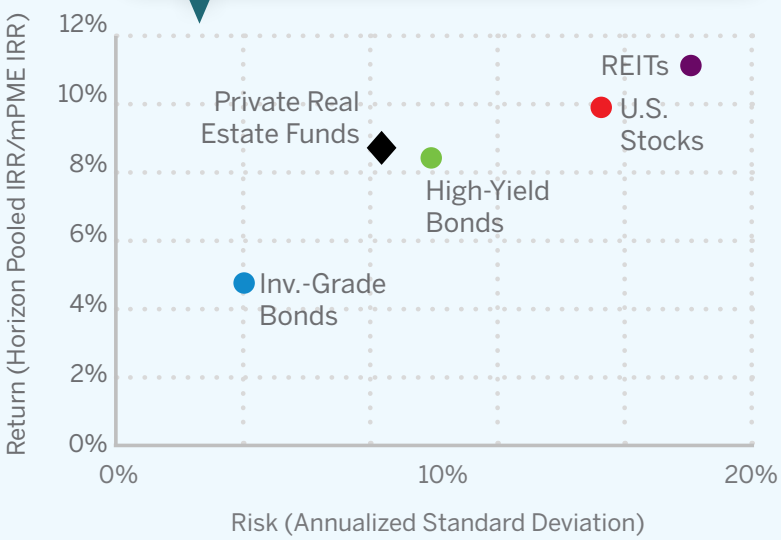
Lower volatility

The chart to the right shows that private real estate has generated an attractive mix of returns and volatility relative to other asset classes.*

The performance of private real estate contrasts starkly with the higher volatility of publicly traded REITs; this distinction is important for those seeking a lower-volatility outcome. As noted above, private real estate valuations generally only change according to periodic property appraisals, whereas REITs, like stocks and bonds, are subject to open-market volatility.

**We want to acknowledge the problems inherent in gauging the volatility of private real estate and comparing it to that of daily-liquidity asset classes. Private real estate is valued quarterly, and, because its returns are dollar-weighted, each quarterly return figure is dependent on the cash flows that preceded it. These facts make it very difficult to truly compare the volatility of private real estate in an apples-to-apples manner with stocks or bonds.*

Risk/Return of Private Real Estate vs. Other Asset Classes (Q4 1988–Q4 2016)

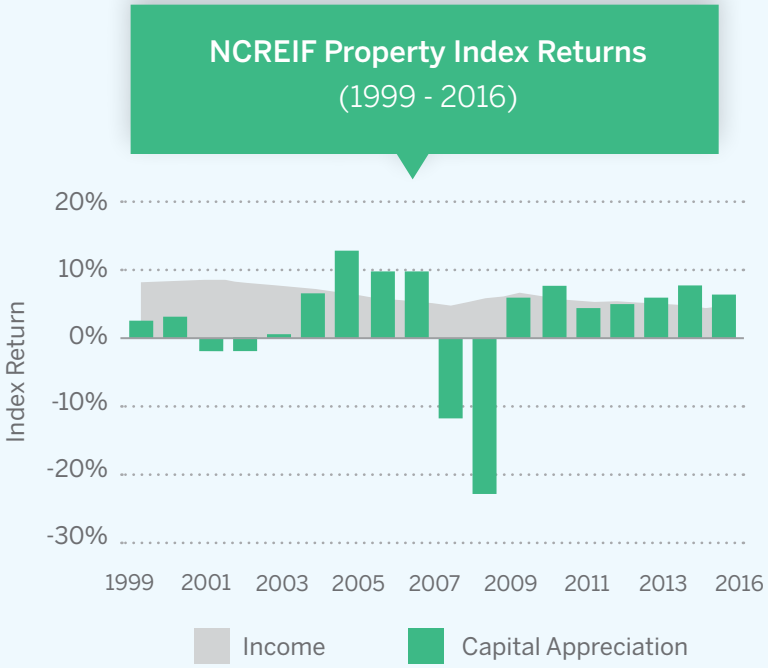


Source: Thomson Reuters. Asset classes are represented by the Cambridge Associates Real Estate Index for Private Real Estate Funds, the FTSE NAREIT Index for REITs, the S&P 500 Index for U.S. Stocks, the Bloomberg Barclays Aggregate Bond Index for Investment Grade Bonds and the Bloomberg Barclays U.S. Corporate High Yield Index for High Yield Bonds. Returns are expressed in horizon pooled IRR fterms for private real estate funds and in modified public-market equivalent (mPME) IRR terms for other asset classes.

Income generation

Many types of real estate generate income in the form of rent from tenant leases. Income from traditional asset classes, such as bonds, declined markedly after the financial crisis, so the ability to earn income in the private real estate asset class is prized by many investors.

Moreover, the income component of real estate returns tends to be far more stable than the capital appreciation component, as shown in the chart to the right. This stability of income helps to reduce the overall volatility of private real estate. Investors can also fine-tune the income proportion of their private real estate portfolios based on whether their goals are more conservative or aggressive. Those seeking greater stability can target mature property portfolios that produce sustained, predictable levels of high cash flow. Those with more aggressive return goals can target development properties with little or no current cash flow, whose valuations depend primarily on prospective leasing activity.



SOURCE: NATIONAL COUNCIL OF REAL ESTATE INVESTMENT FIDUCIARIES (NCREIF)

Defense against inflation

Real estate is a hard asset that offers partial protection against inflation. Real estate income from rent generally has a clear link to inflation; it resets periodically and adjusts to changing external market conditions, such as rising price levels. In the U.S., many commercial leases include a fixed annual percentage increase; in other countries, annual increases are often tied directly to the country's consumer price index or other market indicators.

One recipe for success in private real estate: Focus on what you can control

Private real estate is attractive as a long-term investment for many reasons, but like many sectors, real estate is cyclical.

We believe that trying to time these cycles is an exercise in speculation. We can't control the economy or predict its near-term direction. Despite this, some real estate funds offer a different kind of control over the intrinsic value of the assets they hold. Many of the best general partners of these funds purchase distinct assets that they can then physically improve, make more operationally efficient or repurpose in some way to potentially enhance returns.

For this reason, when we invest in private real estate, we seek to put our money behind managers who have demonstrated exceptional skill over long periods of time, throughout several real estate cycles, and by so doing, generated strong returns. We look for managers who have shown the ability to assemble conservatively leveraged, concentrated real estate portfolios that can benefit from their property-specific operational skills.

We believe that backing managers with this kind of demonstrable experience and expertise gives us the best chance of earning attractive and consistent returns over time.

How we deploy private real estate in portfolios

We help clients build private real estate allocations in a variety of ways. For some, we pursue investments in individual private real estate funds. For others, a more programmatic approach may be preferable, in which we consistently create and launch diverse multimanager funds across a series of vintage years. We choose investment vehicles for each client that help them build a diversified exposure to private real estate.

Whichever structure we use with a client, we are looking for the same kinds of underlying real estate managers. We favor operators with strong specialization in a particular geography or property type. We seek partners who self-source and self-manage investments, which removes an added layer of fees from the process. Finally, ideal managers will have operational capabilities that enhance their control, efficiency and flexibility to deal with changing market conditions.

Ultimately, when it comes to private real estate, we don't believe that there is a wave to catch, or a "right" place or time to invest. Our focus is entirely on building a solid foundation of high-quality real estate managers who, in our view, give our clients a good opportunity for long-term success.

Correlation, in the finance and investment industries, is a statistic that measures the degree to which two securities move in relation to each other.
Liquidity refers to the ease and facility with which an asset may be bought or sold.
Real Estate Investment Trusts (REIT) are companies that own and/or operate income-producing commercial real estate assets. The corporate structure of a REIT exempts the company from corporate income tax if it pays a certain proportion of its taxable income to shareholders.
Volatility is a statistical measure of the dispersion of returns for a given security or market index.
The **Bloomberg Barclays U.S. Corporate High Yield Bond Index** measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below. Bonds from issuers with an emerging markets country of risk, based on Barclays EM country definition, are excluded. Barclays Indices are trademarks of Barclays Bank PLC.
The **Barclays U.S. Aggregate Bond Index** represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities.
The **Cambridge Associates Real Estate Index** represents the performance of the private real estate fund universe, based on data compiled from (647) real estate funds (including opportunistic and value-added real estate funds) including fully liquidated partnerships, formed between (1988) and (2016). Performance is expressed as pooled horizon internal rates of return, net of fees, expenses, and carried interest.
The **FTSE NAREIT** All REITs Index is a market capitalization-weighted index that and includes all tax-qualified real estate investment trusts (REITs) that are listed on the New York Stock Exchange, the American Stock Exchange or the NASDAQ National Market List.
The **NCREIF Property Index** is a quarterly time series composite total rate of return measure of investment performance of a very large pool of individual commercial real estate properties acquired in the private market for investment purposes only.
The **S&P 500® Index** represents the large-cap segment of the U.S. equity markets and consists of approximately 500 leading companies in leading industries of the U.S. economy. Criteria evaluated include market capitalization, financial viability, liquidity, public float, sector representation and corporate structure. An index constituent must also be considered a U.S. company.