Investing in Real Estate

Real estate may offer an important investment opportunity to help diversify portfolio holdings.

Executive summary

Ownership of real estate has historically been viewed as a form of investment. Until recently, it was not considered to be a common portfolio holding except by institutions and ultra-high net worth individuals. However, it has come to be recognized as a meaningful and mainstream asset class that can serve as a potentially valuable component of an investment portfolio.

The introduction of Real Estate Investment Trusts (REITs) in the United States in the 1960s made large-scale commercial real estate investments accessible to individuals. Since that time, a number of vehicles have been created to enhance the investment profile of real estate in individual portfolios.

Real estate as an investment applies to a broad array of property types including:

- Industrial
- Office
- Retail
- Residential
- Farmland
- Timberland

In this paper, we outline why we believe the addition of real estate holdings, as appropriate, within a broadly diversified portfolio mix can help work towards meeting a wide range of client objectives.

Investments in commercial real estate

There are two primary approaches we recommend to include commercial real estate as part of an investment portfolio—direct and indirect investment strategies.

Direct investment strategies: Direct ownership of real estate is defined as owning an actual property rather than simply investing in shares of a REIT. Ownership can be vested by means of a limited liability company (LLC), limited liability partnership (LLP), corporation or by an individual. The key factor is that the owner has the ability to directly manage the asset.

Important disclosures provided on page 5.

As with any investment, it is important to ensure that direct real estate ownership is consistent with the investor's objectives. Issues that must be addressed include:

- **Appropriateness of the investment.** A risk-averse investor is not likely to be comfortable with the challenges inherent in direct property ownership. Those unable to devote sufficient time to develop an understanding of commercial real estate or who are reluctant to engage a professional for guidance may not be suitable investors. We believe investors with a near-term need for cash and the inability to hold an investment for a long-term period should not invest directly in real estate.

  For those who are identified as suitable investors, we believe the advice and guidance of an experienced real estate professional may be beneficial. These professionals are readily available and can play a critical role in the acquisition of properties. An experienced professional, for example, can help with identifying potential opportunities.

- **Managing risk.** Most properties included in a direct ownership position are held in an LLC or LLP, and the resulting containment of liability within the entity is one way to manage risk. Corporate ownership is another way to contain risk but may have other drawbacks from a tax perspective. An additional risk containment strategy includes responsible property management. A professional manager seeks to provide a high level of skill in the oversight of property, a critical step that may help to generate consistent returns through various market cycles or avoid costly surprises.

Indirect investment strategies: REITs have emerged as the most popular way for individuals to invest in real estate in the United States (outside of home ownership) and are gaining a foothold across the globe. They appeal to individuals because of their accessibility and generally liquid nature.

A REIT is an entity that owns and actively operates income-producing commercial real estate. Tax laws require that REITs pay out at least 90 percent of income to shareholders, though in practice, most pay out 100 percent. This can result in very competitive yields. The income is taxable to investors, as are any capital gains generated by a REIT.

There are three primary forms of REITs:

- **Equity REITs** are the most common type of REIT. They actively own and operate commercial properties such as malls, office buildings, apartment complexes, timber land, resorts and healthcare facilities.
- **Mortgage REITs** are an investment in loans to property owners or operators or indirect financing through the acquisition of specific loans or bundled loans such as mortgage-backed securities. These make up less than 10 percent of the REIT market.
- **Hybrid REITs** are a combination of equity and mortgage REITs. They make up a negligible part of the REIT market.

While REITs dominate the indirect investment category, there are other vehicles that can provide individuals with the opportunity to invest indirectly in REITs. These include:

- **Real Estate Operating Companies (REOCs).** These are nearly identical to REITs, except rather than paying earnings to shareholders in the form of dividends, the earnings are reinvested into the business. REOCs are more common in overseas markets that have a different tax structure than the United States.
- **Real estate mutual funds.** Rather than own properties directly, these funds invest primarily in a portfolio of REITs. Holdings are priced daily, as with any mutual fund, and they provide daily liquidity for investors.
- **Stock of publicly traded companies within the real estate industry.** Indirect investment in real estate can also be achieved by owning stocks of companies in the construction, building products and homebuilding industries.
- **Bundled securities.** Investors can directly access bundled securities that are backed by residential or commercial mortgages (mortgage-backed securities).

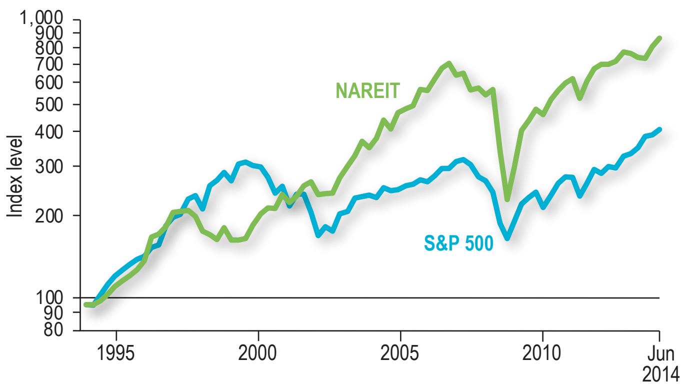
How real estate investments can contribute to a diversified portfolio

Real estate can offer a variety of potential advantages when part of a broadly diversified portfolio, including:

Returns and comparative performance: Investments in commercial real estate have the potential to generate both annual income (from lease payments) and capital appreciation. Income is generally paid regularly over the holding period of the investment, while capital appreciation may be realized when the investment is sold.

Market-traded REIT stocks, measured by the NAREIT Index, have outperformed the S&P 500 in most of the last 20 years.

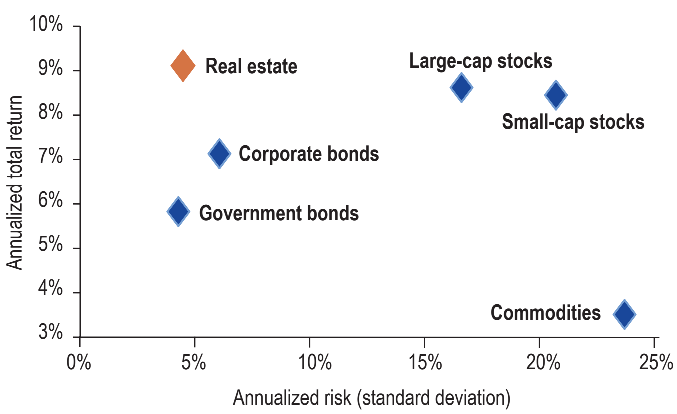
Performance of REITs vs. equities



Source: FactSet; Data period 9/30/94-6/30/14

Real estate also has an attractive risk and return profile. For a 20-year period from 1993-2013, real estate provided average returns that fell between those achieved by equities and bonds. However, when volatility is considered, the risk-adjusted return for real estate has historically been greater than either equities or bonds.

Return and risk profile across major asset classes



Source: Thomson Reuters Datastream. Data period: 3Q 1993-2Q 2013. 1993 is used as a starting point because it was the first time data was consistently available across the illustrated asset classes. Indices used for each asset class: Government bonds=BofA Merrill Lynch Treasury Master, Corporate Bonds=Barclays U.S. Aggregate Corporate Intermediate, Core Real Estate=NCREIF Property Index (NPI), Large-cap Stocks=Russell 1000, Small-cap Stocks=Russell 2000, Commodities=S&P GSCI. Past performance is not an indication of future results. Indices are not available for investment.

Potential for portfolio diversification: Regardless of whether it is a direct or an indirect investment, real estate can provide added diversification to portfolios. It is a notably different asset class compared to traditional equities and fixed income investments and tends to have low or even negative correlation to those asset classes.

Real estate exhibits low correlation to other asset classes

	NCREIF	NAREIT	S&P 500	Russell 2000	Barclays US Agg Bond	MSCI EAFE
NCREIF	1.00					
NAREIT	0.10	1.00				
S&P 500	0.19	0.42	1.00			
Russell 2000	0.07	0.65	0.85	1.00		
Barclays US Agg Bond	-0.06	0.09	-0.03	-0.13	1.00	
MSCI EAFE	0.10	0.44	0.78	0.79	-0.27	1.00

Source: Morningstar. Data period: 12/31/93-12/31/13
Data shows correlation among returns over this 20-year time period. Past performance is not an indication of future results. Indices are not available for investment.

At a time when different asset classes, even on a global basis, are becoming more highly correlated, real estate can offer potential diversification benefits by retaining a low correlation to equities. The diversification value of different types of real estate investments may vary. For example, publicly traded REITs listed on national stock markets may have a higher degree of correlation to stocks. As illustrated in the above table, direct investments in real estate have typically achieved the lowest correlation to traditional equities and fixed income investments.

Cyclical hedge: Because a number of properties, primarily office, retail and industrial spaces are leased to tenants for long terms (five, 10 or even 20 years), they may help provide a defense against downturns that occur in a typical economic cycle. Other forms of real estate, such as lodging, self-storage and multifamily units have shorter lease terms of one year or less. This may not provide the same type of protection against down cycles, but they can offer the investor the potential to profit from increased lease rates during periods of economic improvement.

The potential for inflation protection: Many commercial leases include inflation "escalators" that will tie lease rates to a measure of inflation such as the Consumer Price Index. Base rents generally rise in line with living costs (or some other inflation measure), which can potentially provide some degree of inflation protection for investors. An additional inflation hedge may be achieved because costs of land, materials and labor are factored into determining a property's replacement cost.

Volatility: Directly owned real estate historically has a significantly lower level of volatility than equities, while generating comparable returns over time. This is due in part to the fact that direct real estate is not valued on a daily basis. Instead, values are obtained through an appraisal process that generally tends to be subject to less short-term fluctuation (compared to the daily pricing of equities and mutual funds).

REIT shares are subject to more volatility than direct investments because they are traded on stock markets and are continuously subject to changes in valuation.

Tax and estate planning: Taxes are always an issue, and this is especially true for those with direct real estate holdings. While U.S. Bank and its representatives do not provide tax advice, there are tax professionals who can provide guidance on how to capitalize on potential tax strategies with property ownership, such as like-kind (1031) property exchanges. Indirect real estate investors also have tax issues to consider and will want to work with their tax professional to assess the after-tax return potential of specific real estate investments.

Potential challenges

Just as they would with any investment, investors need to be aware of some of the risks that are associated with real estate. Some are unique to this asset class and others are not, including:

Liquidity: Exiting a direct investment in commercial real estate can be difficult and expensive. Pricing, market exposure and sale negotiations can extend for months or years. An investor with a need for liquidity should not directly own commercial real estate, but may benefit from an indirect investment in real estate, such as through REITs, which offer greater liquidity.

Specialized knowledge: Direct investment in real estate requires specific knowledge of the local market, asset type and market trends. Once properties are acquired, there are numerous issues related to the ongoing management of the property. Additionally, each asset type requires a slightly different skill set. Utilizing real estate professionals may help offset these risks.

Those making indirect investments may have limited familiarity with REITs and similar vehicles. The guidance of professional managers, advisors and specialists can help in managing indirect real estate holdings.

Additional risks: Many potential challenges could be factors when direct investments are made.

- Real estate can be a depreciating or deteriorating real asset, and issues generally arise with properties during the course of ownership. Simple things, such as painting or replacing an air conditioner, might cause a minor disruption in cash flow, whereas replacing a roof is often a major expense and needs to be planned and budgeted.
- Renovations or re-positioning the purpose of the property may be required in order to effectively compete for tenants as markets and businesses are ever changing. Renovating a property may be a major expense and could be necessary at a time when cash flow is restricted, such as when a tenant moves out.
- Property may be subject to potential damage or may require a large capital investment. Insurance is maintained to compensate for damage or destruction, but the deductible and the potential loss of rental income or the inconvenience of a temporary relocation can cause disorder.

Monetary reserves may be needed to deal with these types of risks to the property or to help mitigate an impact to the income stream.

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We can provide guidance on strategies for investing either directly or indirectly in real estate.

Conclusion

It is increasingly evident that in suitable circumstances, real estate can offer the potential to become a contributing asset class in an investment portfolio. We can provide guidance to help you meet your objectives by recommending an appropriate real estate solution within a broadly diversified asset mix.

If you have an interest in indirect investments, we may recommend real estate mutual funds (investing in REITs) or REIT-focused separate accounts. The investment options available on our platform have been through a thorough due diligence process. We analyze a variety of factors, including each management firm's philosophy, investment process, strategy, performance and fees before choosing those that will meet our standards for individual investors.

If you are interested in direct investments, we offer the guidance and support of experienced commercial real estate professionals located across the nation. They can provide the specialized knowledge that may be critical to the direct investment process, from acquisition to ongoing management to the ultimate disposition of the properties. If you are interested in direct investments, we encourage you to talk with your Wealth Management Advisor early in the process to discuss specific objectives you hope to achieve through direct real estate ownership.

Real estate may not only offer an important investment opportunity for individuals, but in many cases could be a core component that can help effectively diversify a portfolio. We're ready to put our experience to work to help structure personalized real estate solutions to meet your specific investment objectives.