Diversification and Passive Income: Why Multifamily Real Estate Can Be a Great Option for Diversification in Uncertain Times

It is well understood among investors that diversifying investments is great practice and critical in helping sustain overall portfolio performance. The question, then, is which asset class should one invest in to add a level of diversification that is not directly affected by market forces like stocks and bonds are? An investor has many options; however, one that is often mentioned is *income producing* real estate.

Many Insurance companies, Family Offices, large Private Equity firms and individual high net worth investors use income producing real estate as an investment tool to add diversity against stocks and bonds. These types of investments earn consistent, passive income that is not affected by the constant fluctuations seen in traditional investments such as stocks or bonds.

Interestingly, many individual investors' portfolios do not include individual real estate investments. Usually this is not by design, but rather it reflects the bias towards stocks and bonds because they are readily available and easier to research. It is not uncommon for our company to hear: "Why don't I just purchase shares in a REIT if I want to invest in real estate?" Well, this is certainly an option but exchange traded REIT's are highly correlated to the stock market and can be influenced by the same market forces that make stocks and bonds volatile.

Most individual investors do not realize that the same types of income producing real estate investments that many savvy institutional and high net worth investors use ARE available to them and that they are much easier to begin investing in.

Direct investment in income producing real estate is a great way to earn passive income while still protecting an investment from the roller-coaster market cycles.

Below is a summary of five reasons why investing in income-producing real estate can add diversification and passive income to any investment strategy.

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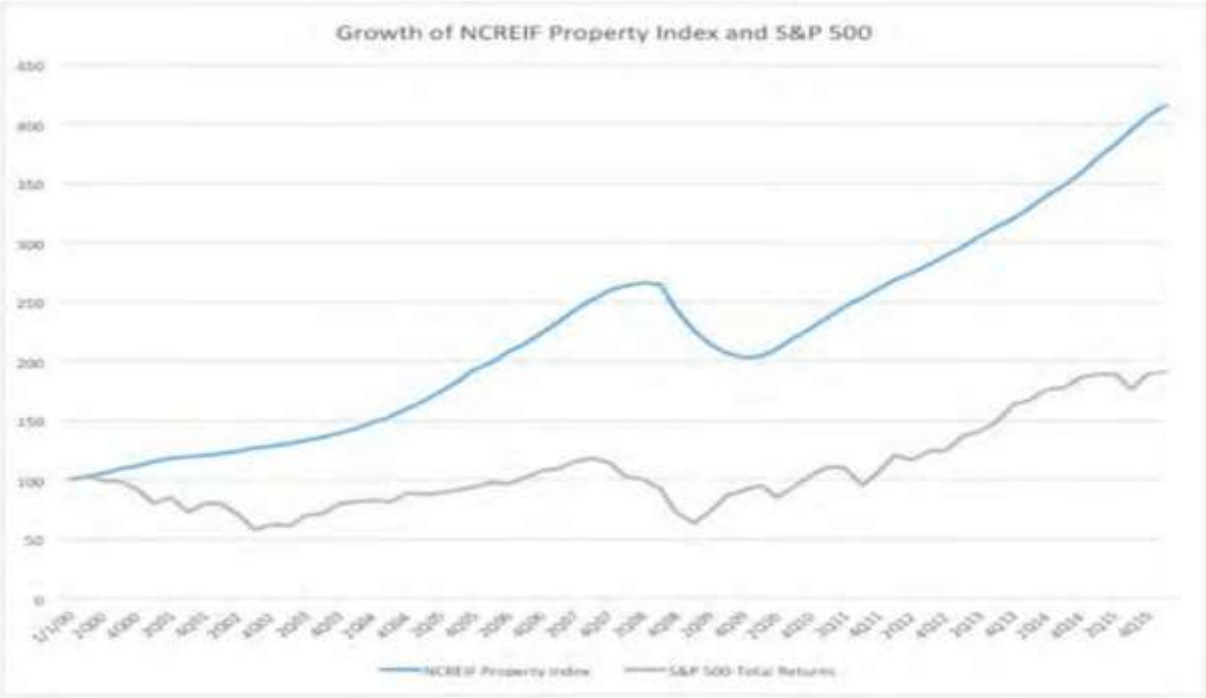
Historically Higher Returns

A quick look at the historical returns reveals that not only has real estate outperformed the S&P 500 by a wide margin, it is also less volatile and diversifies your portfolio.

If one had invested $100 in a diversified portfolio of institutional quality real estate in 2000, that investment would be worth $415 as of March 31, 2016. That is a 9.2% average annual total return. The same investment in the S&P 500 would be worth $192. The real estate returns are based on the NCREIF NPI index* of unleveraged, core properties (Multifamily, retail and Industrial) so that most real estate investments, even with modest leverage, could be expected to earn even higher returns.



Source: National Council of Real Estate Investment Fiduciaries (NCREIF) and Standard & Poors

(In our report "Stocks v. Real Estate- Which Has a Better Return?" we take a deeper dive into why real estate has shown to be a better return over time.)

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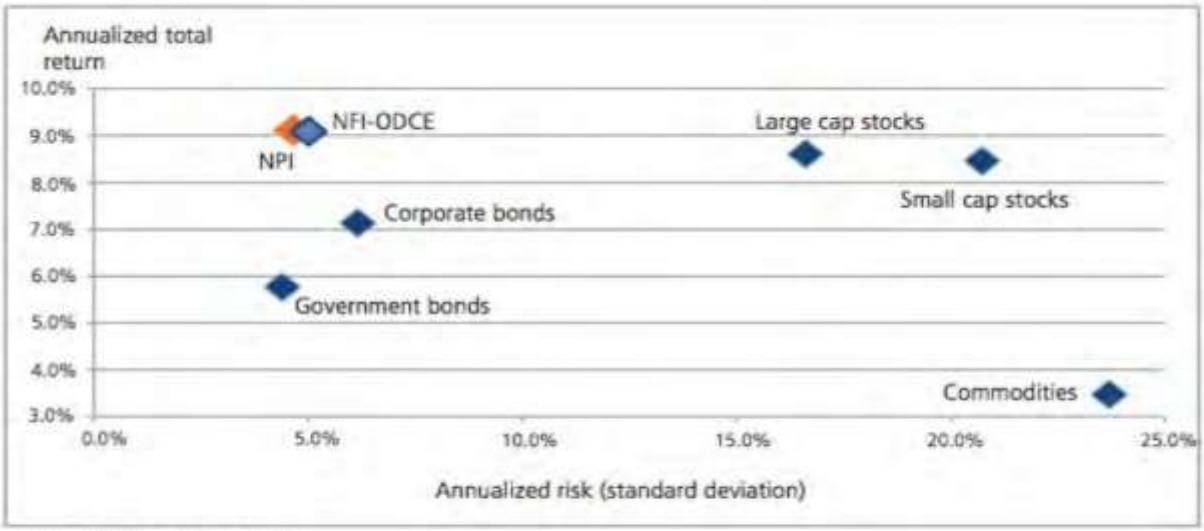
Lower Volatility

In addition to producing higher returns, real estate is less volatile than stocks. Surprisingly, it is also less volatile than corporate bonds. This can be measured by looking at the standard deviation of each asset type. The following graph is taken from an excellent paper published by Met Life: US Core Real Estate - Past, Present Future View 2013.

Collectively, the orange diamond represents the NCREIF NPI index*, and shows that real estate generates higher returns than stocks with volatility comparable to that of corporate bonds. The nearby blue diamond, NFI-ODCE, is a different NCREIF index that tracks the performance of institutional real estate funds, rather than individual properties.

20 Year Return and Risk Profile Across 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.

[1] We used 1993 as a starting point because it was the first time data was consistently available across these asset classes. Although core real estate is typically compared to just equities and bonds, we recognize that modern portfolios hold a wide variety of assets.

**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. All properties in the NPI have been acquired, at least in part, on behalf of tax-exempt institutional investors - the great majority being pension funds. As such, all properties are held in a fiduciary environment. The National Council of Real Estate Investment Fiduciaries (NCREIF) is an association of institutional real estate professionals who share a common interest in their industry. NCREIF produces several quarterly*

indices that show real estate performance returns using data submitted by Data Contributing Members from institutional asset managers.

Diversification from Stocks and Bonds

Data continues to support the argument that portfolio diversification is improved with real estate by adding asset classes that have low correlations to stocks and bonds. *It is well understood (and supported) that real assets are powerful diversifiers, with low or negative correlations to traditional stocks and bonds.*

In a January 2014 paper by TIAA-CREF Asset Management titled "Private Real Assets: Improving Portfolio Diversification with Uncorrelated Market Exposure", direct real estate has a correlation of 0.23 to stocks, which is significantly lower than the correlation of REITs to stocks, at 0.58 (below).

While real estate, like any asset class, is subject to overall economic trends, it is insulated from many of the factors that cause short-term volatility in the stock market. income producing properties are subject to leases that continue to generate steady income regardless of stock market gyrations. As private investments, they tend not to move in lockstep with traditional assets or commodities because they are relatively illiquid and not exposed to speculative trading in public markets such as stocks and bonds.

Correlations of Real Assets, Commodities, and REITs (1992–2012)

TIAA White Paper on Real Assets and Diversification

Real assets had low correlations to other asset classes — and to each other

	Stocks	Bonds	Private real assets			Public commodities and real estate		
Market Indexes	Russell 3000	Barclays U.S. Aggregate	NCREIF Real Estate	NCREIF Farmland	NCREIF Timberland	NAREIT	GSCI Agriculture	Timber proxy
Russell 3000	1.00	0.03	0.23	-0.03	0.18	0.58	0.26	0.62
Barclays U.S. Aggregate	0.03	1.00	-0.24	-0.37	0.14	0.14	0.03	-0.09
NCREIF Real Estate	0.23	-0.24	1.00	0.39	-0.05	0.13	0.19	0.03
NCREIF Farmland	-0.03	-0.37	0.39	1.00	0.20	-0.04	0.06	-0.18
NCREIF Timberland	0.18	0.14	-0.05	0.20	1.00	-0.02	0.11	0.02
NAREIT	0.58	0.14	0.13	-0.04	-0.02	1.00	0.22	0.67
GSCI Agriculture	0.26	0.03	0.19	0.06	0.11	0.22	1.00	0.19
Timber proxy	0.62	-0.09	0.03	-0.18	0.02	0.67	0.19	1.00

Indexes in the matrix represent the following markets: Russell 3000 Index — U.S. public equities; Barclays U.S. Aggregate Bond Index — U.S. investment-grade bonds; NCREIF Real Estate Index — privately-held U.S. commercial real estate; NCREIF Farmland Index — privately-held U.S. farmland; NCREIF Timberland Index — privately-held U.S. timberland; NAREIT Index — publicly-traded U.S. real estate companies; S&P GSCI Agriculture Index — a public index representing a range of agricultural commodities; and Timber proxy — a proxy index created by TIAA-CREF that combines the S&P Global Timber and Forestry Index (2004–2012) with the returns of companies representing 4% or more of the index between 1992 and 2003.

Source: TIAA-CREF

A Hedge Against Inflation

Income producing real estate offer low or negative correlations with traditional assets such as stocks and bonds because they are relatively illiquid, infrequently traded, and insulated from commodity speculation, such as options trading, which as we have seen repeatedly cause havoc with the exchange traded markets.

With relatively short (typically one year) lease terms found with apartment complexes, asset managers can increase rents (income) frequently to adjust for any fluctuations in inflation. At a granular level, the ability to adjust rental rates and lease terms gives the asset manager the ability to adjust to local market demands. This maximizes income and occupancy rates which are both key factors in stabilizing a property for long-term revenue and investment growth.

Growing Demand

Recent data from *The Bureau of Labor Statistic* and numerous industry research groups all point to a lasting demand for quality rental housing for both Millennials and Baby-boomers alike. Numerous demographic data suggests that this demand will outpace supply for next few decades.

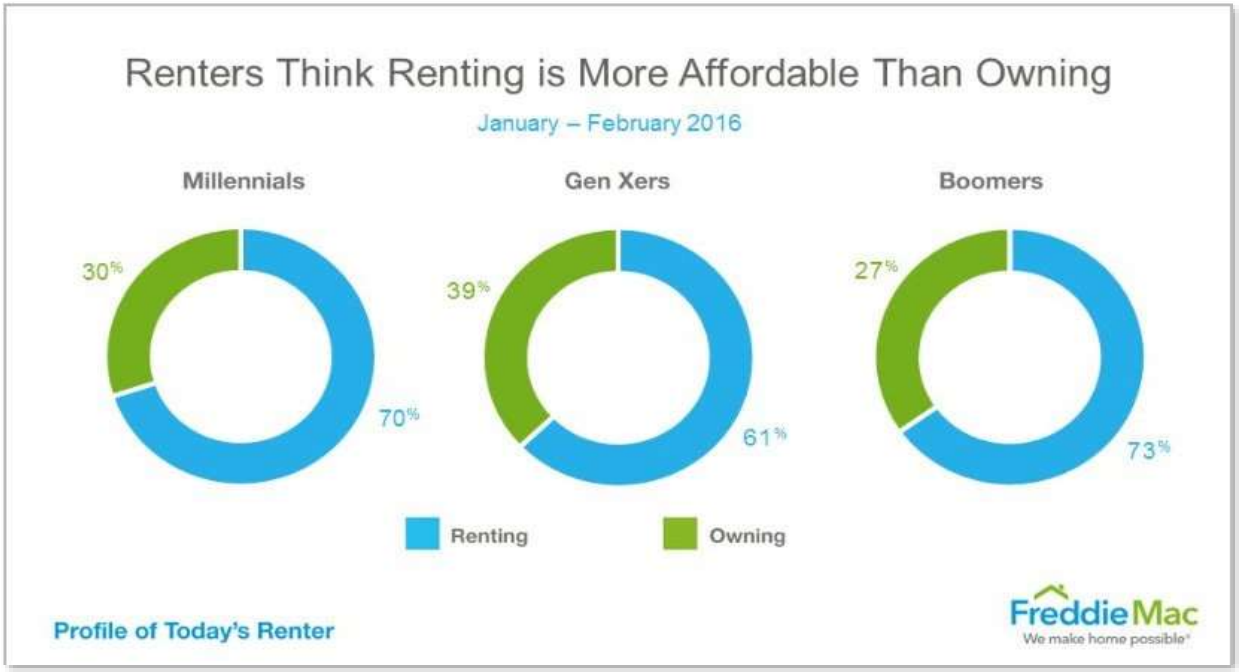
Minimal wage growth, coupled with burdensome college debt, is pushing more millennials out of the homeownership market and into rental housing. In addition, uncertainly with pension funds and a desire for more “care-free” living is supporting more Baby-Boomers to opt for renting rather than homeownership.

According to a 2016 study from the Joint Center for Housing Studies of Harvard University, over 36% of U.S. households rented in 2015. This is the largest share since the late 1960s. The number of renters increased by 9 million over the previous 10 years, which is the largest 10-year gain on record. Demand has been driven by all age groups, with the largest gains measured among older renters and families with children.

This high level of demand has driven vacancy rates steadily downward since 2010, falling [on average] to 7.1% at the end of 2015. Additionally, the amount of rents increased 3.6% during 2015, based on the Consumer Price Index for rent of primary residences. Adjusted for inflation, it has been three decades since either indicator of the rental market reached such levels.

Despite rent increases and feeling burdened by finances, seven in ten renters currently feel renting is a more affordable choice than homeownership. Even among those who plan to move towards homeownership, half of those still see renting as a more affordable option.

Interestingly, these views are similar across the generations: 70% of Millennials, 61% of Gen Xers, and 73% of Baby Boomers think that renting is a more affordable choice. Freddie Mac commissioned Harris Poll to survey U.S. adults online each quarter to get their perceptions about renting. The most recent survey was completed in January and February



of 2016. Among 4,063 participants, 1,527 were renters. Age, sex, race/ethnicity, education, region and household income were weighted to bring them into line with their actual proportions in the population.

Findings from a recent Survey of 55+ homeowners conducted by GfK, on behalf of Freddie Mac, suggest that shifting housing choices by the Baby-Boomers and those older may significantly exacerbate the already acute shortage of [multifamily] housing in the years to come. An estimated 6 million homeowners, and nearly as many renters, prefer to move again and rent at some point. Of those homeowners and renters that expect to move again, over 5 million indicate they are likely to rent by 2020.

Summary:

Whether one prefers individual equities or is more comfortable spreading risk within mutual funds, over time stocks can give them the return he or she is looking for to reach their financial goals. However, due to constant fluctuations seen in traditional “Market” type investments such as stocks or bonds, many Insurance companies, large Private Equity firms and individual high net worth investors use income producing real estate as an investment option to add diversity to their investment portfolio, especially in uncertain or “over-heated” market conditions.

As one can see above, these are just five of the many reasons why investing in income-producing real estate, such as apartment complexes, can help add diversification to any size investment portfolio.

If you want to learn more about how Cambridge Equity Partners can help you invest in income-producing real estate, please contact us today to review how our current investment opportunities can provide passive income and diversification for you.

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