Core Private Real Estate Benefits DC Investors in the Post-COVID-19 World

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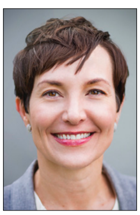

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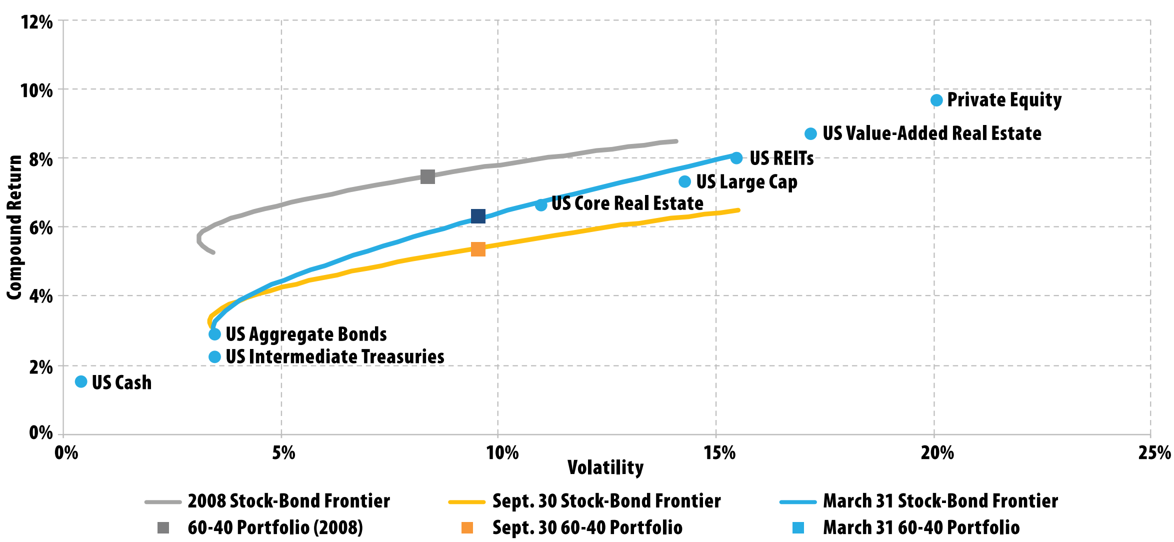
While 2020 will rightly be remembered as the year of the virus, it is also noteworthy in that it marks the end of the expansion cycle that followed the great financial crisis. The latter half of the first quarter presented record equity volatility, GDP contraction, unemployment, stimulus measures, and a sharp decline in interest rates, such that many government bonds and safe haven fixed income yields have reached negative territory in real terms. This has exacerbated investors' already challenging search for complementary perceived safe assets that may provide diversification with stable and enhanced long-term yields. Furthermore, while the elevated levels of expansionary monetary and fiscal policies enacted in response to the COVID-19 pandemic have created a support mechanism for the economy in the short term, these unprecedented actions may potentially lead to reflation in the intermediate term as demand picks up from deeply subdued levels.

For defined contribution (DC) investors, these challenges present very real risks to their retirement security. In this fluid and changing environment, DC investors need to generate portfolio income, promote strong risk-adjusted asset growth, and mitigate future unforeseen drawdowns for participants to meet their retirement goals. This is true regardless of how long employees have until retirement, given that the low interest rate environment and potential risk of inflation could present value erosion over time.

The benefits of core private real estate—greater diversification from equities and fixed income and capital preservation potential, attractive income yields and risk-adjusted returns, and potential for inflation protection without increased volatility—offer the potential to meet DC investor needs for both participants further from retirement whose investment horizon may span multiple cycles and participants closer to retirement for whom inflation sensitivity and capital preservation are paramount. The income-driven stable return profile of core private real estate, where quality of income is key, reduces maximum drawdowns, mitigating value loss for participants during periods of dislocation and strengthening compounded risk-adjusted returns over time.

Exhibit 1: The Next Cycle—Stronger Risk-Adjusted Returns With Private Real Estate



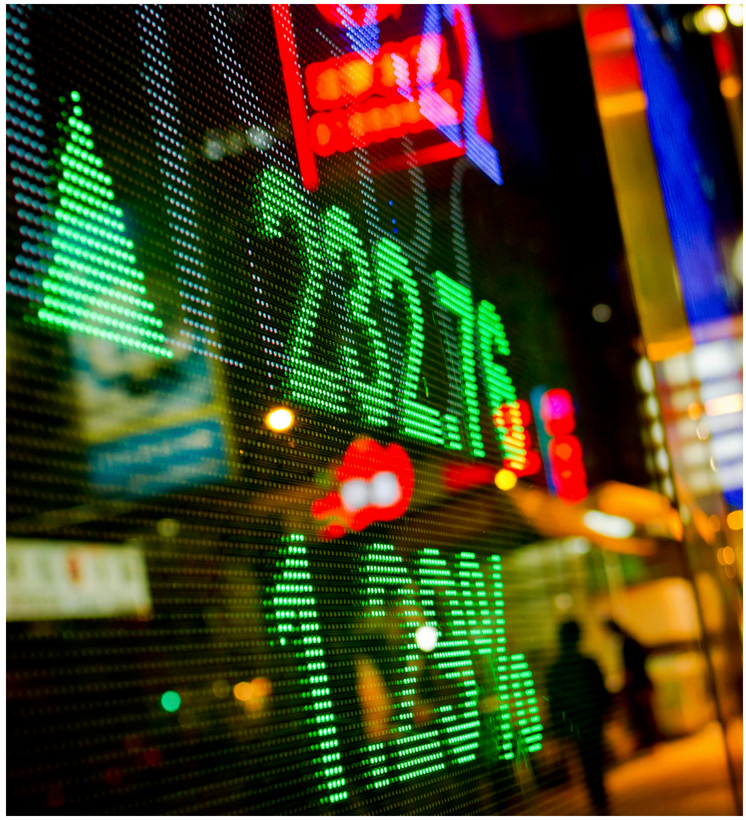
Source: Long-Term Capital Market Assumptions, J.P. Morgan Asset Management; data as of April 2020

The Start of a New Business Cycle

The COVID-19 pandemic suggests the beginning of a new business cycle, clearly illustrated by the steepening of the current stock-bond efficient frontier in March 2020 compared to those dating from the financial crisis (2008) and pre-COVID-19 time frame in September 2019 (Exhibit 1). Given the steep reduction in interest rates, fixed income returns will clearly continue to be muted over the long term, and equity returns look relatively more attractive. Core real estate is favorably positioned on the March 2020 frontier to strengthen risk-adjusted returns, given the asset class's equity-like total returns, enhanced income levels compared to fixed income, and a risk profile that falls between stocks and bonds. Our updated long-term capital market assumptions, which have a 10- to 15-year time frame, increase the US core real estate return assumptions by 80 basis points to 6.6%, even further supporting its inclusion in a multi-asset portfolio looking ahead. Given the equity rally at of the time of writing this article, core real estate returns may ultimately be in line with future equity returns, but with lower volatility, moving forward.

In an environment in which DC investors are searching for yield and suffering increased equity market volatility, core private real estate may offer a solution with its strong, income-driven return profile. For investors closer to retirement, steady portfolio income and drawdown mitigation provide valuable portfolio support when account balances may be at their highest. The equity orientation of private real estate, particularly following a dislocation, supports appreciation potential and stronger risk-adjusted total returns for participants with longer time horizons. Healthy relative income yields and stronger risk-adjusted portfolio returns are supported by core private real estate's steady and predictable income profile, the quality of which is critical, as we witnessed during the current market dislocation and conversation around lease payments.

For DC investors in a post-pandemic world, market dynamics suggest that a more tactical entry point into a long-term strategic real estate allocation would

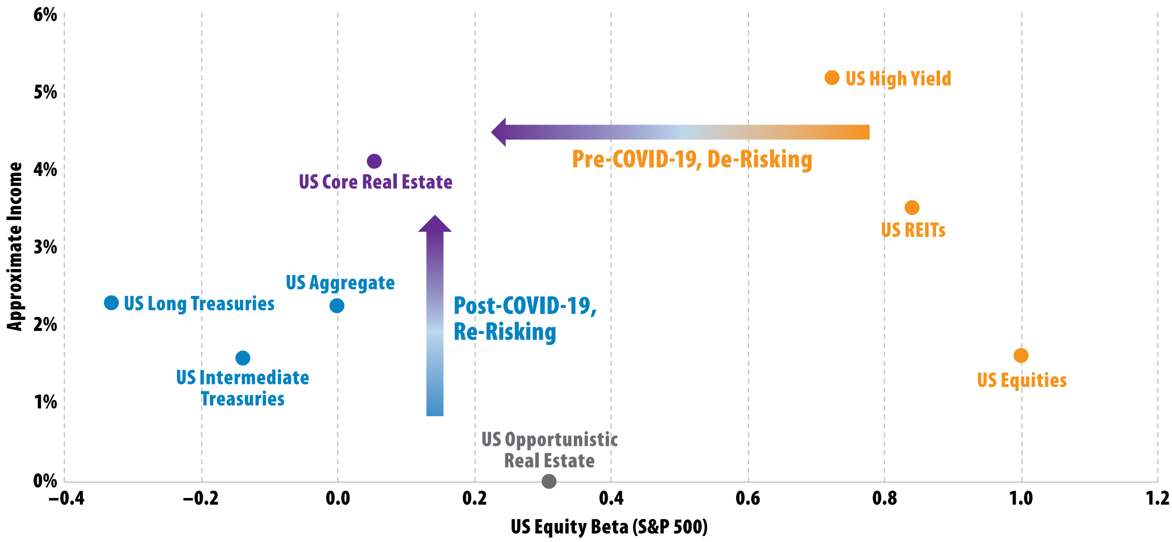


be funded from fixed income allocations that are expected to underperform relative to equity-oriented asset classes, given depressed bond yields. Real estate also has the benefit of countering equity risk within portfolios, which tends to present the largest investment risk to DC plan sponsors and participants.

Diversification and Volatility

This conversation is even more salient for DC investors in the context of diversification and volatility, particularly given the broad macroeconomic factors at play that could impact retirement outcomes. Because equities typically dominate DC multi-asset portfolios and therefore present the greatest risk to participants, it is desirable to consider investments with lower equity beta to diversify away some of the systematic risk. Fixed income has traditionally held this role; however, current and expected income levels in the asset class make it increasingly less effective and attractive looking ahead. Core real estate,

Exhibit 2: Rethinking Funding Sources in a COVID-19 Regime



Sources: J.P. Morgan Alternatives Solutions Group, Bloomberg, Barclays, S&P, FTSE, NAREIT, NCREIF
Notes: Data are as of December 31, 2019. Approximate income is represented by yield to worst for fixed income, 12-month dividend yields for equities, and NCREIF Fund Index—Open End Diversified Core Equity one-year income return for core real estate. Betas for all asset classes are based on full-cycle annual calendar year returns from 2007 to 2019 against the S&P 500.

deriving two-thirds or more of its total return from contractual cash flows from typically high-quality tenants, fits neatly within the low beta/high income quadrant when beta and income, or diversification and certainty of outcomes, are plotted (Exhibit 2).

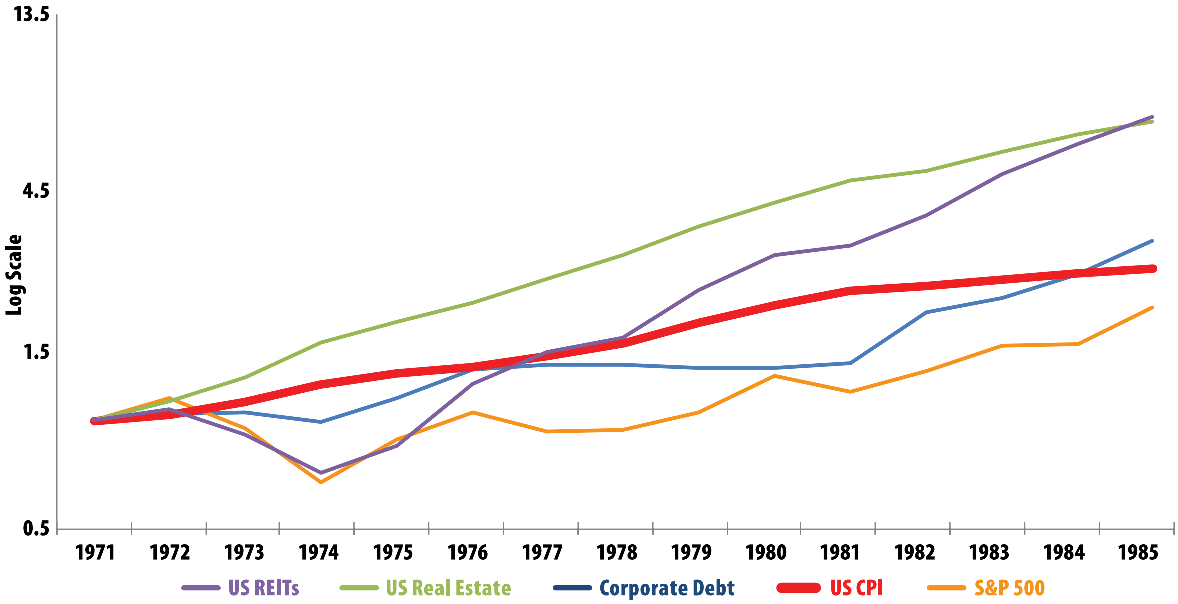
In a post-pandemic environment, this has important implications for determining funding sources for building a core real estate allocation, particularly for DC plan sponsors that have less experience including the asset class in their professionally managed vehicles. Although funding new core real estate allocations from high yield and equities was an attractive proposition to reduce risk of a correction, in the more stabilized, post-pandemic phase of recovery, fixed income is an increasingly attractive funding source. Core real estate's enhanced income potential and ability to participate in upside appreciation while diversifying equity risk enable stronger risk-adjusted returns and a smoother path for plan sponsors and their participants as they prepare for retirement.

Looming Inflation Risk

Diversification and income aren't the only tenets of core real estate that support its inclusion in multi-asset portfolios. While these characteristics impact a plan participants' income, total return, and portfolio valuation at retirement, the potential risk of inflation threatens future purchasing power. The risk of reflation in the intermediate term is now a "well-known unknown," given the amount of liquidity the US government has injected into the capital markets for the 2008–2009 financial crisis, its recovery, and the current COVID-19 pandemic. People may have memories of muted inflation in the developed world for more than three decades, but when inflation rises, it can be punitive to real portfolio returns and overall retirement outcomes, leaving participants with fewer savings to last for shorter periods of time than needed.

In the last bout of rapidly rising inflation, core real estate assets outpaced inflation, while equities and corporate debt were negative or at par in real terms for a 15-year period (Exhibit 3). The world has been low inflationary for the past three decades, with its highest levels in the 1970s and 1980s. While we don't think those levels of inflation will be reached in the intermediate term, empirical evidence suggests that in a period of inflationary

Exhibit 3: Real Returns Matter—Nominal Return and Inflation Indices, 1971–1985



Sources: Federal Reserve, S&P 500, FTSE EPRA NAREIT, J.P. Morgan Asset Management—Alternatives Solutions Group

spikes, real estate outperforms inflation compared to other asset classes. This is similar to the lease structures in commercial real estate that typically allow for rent escalations and a pass-through of operating expenses to help compensate landlords for inflationary costs associated with running assets. Core private real estate presents lower volatility than most public market, inflation-sensitive asset classes available to DC participants, meaning that DC participants can address inflation concerns through a core real estate allocation without paying the price of increased volatility while still contributing to enhanced income, mitigated drawdowns, and strong risk-adjusted returns.

Conclusion

While the income, diversification, and inflation challenges DC plan sponsors and participants face may seem daunting, they are by no means insurmountable. The start of a new business cycle presents a tactical entry point, in a post-pandemic world, to a long-term strategic real estate allocation that can diversify equity risk when fixed income may be ill-equipped to do so. Real estate can augment portfolio income in a period of extraordinarily low interest rates and support stronger risk-adjusted real returns over the long term in an effort to protect participant purchasing power. A new business cycle presents an opportunity for plan sponsors to reorient their professionally managed solutions toward the inclusion of core real estate to support their participants' near- and long-term retirement health. ■

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