

Be “Quadrant Smart”: A Focus on Equity Real Estate



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Investors should consider a holistic approach to the real estate asset class across the “four quadrants.” This means considering opportunities spanning both equity and debt positions on one dimension and both private and public market executions on the other (Exhibit 1). Doing so captures the full gross capitalization of real estate, enhances diversification, and opens opportunities to capture the best relative value. We call this being “quadrant smart” in LaSalle’s recently released *ISA Portfolio View 2024*, an annual report on portfolio construction.



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Allocating between real estate debt and equity investing should be driven by risk appetite, views of relative pricing, and an investor’s broader portfolio considerations. Although debt investing has been quite topical over the past two years and covered by multiple investment managers, including LaSalle (see *ISA Focus: Investing in Real Estate Debt*), this article discusses the relationship between the public and private avenues to real estate equity investment.

Institutional investors tend to be well versed in private equity real estate investing but less consistent

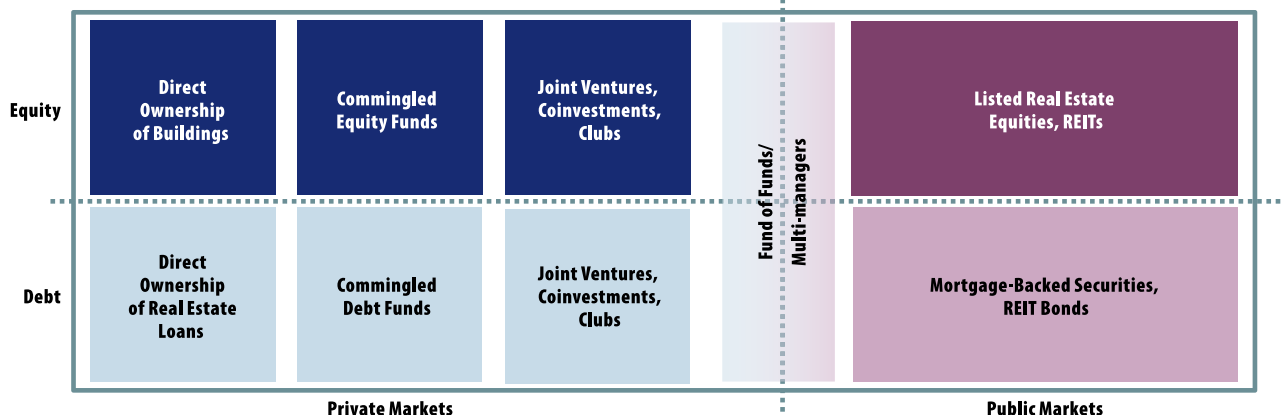
in their approach to the publicly traded side of real estate—even though the public side offers similar characteristics, a broad opportunity set, and often leading signals on the broader market’s direction. This article focuses on how to think about using both sides of the equity real estate investing coin, public and private, to maximize access and potentially improve the overall risk-adjusted return profile.

REITs Are Real Estate

Public equity investing offers ownership of a diversified property portfolio with the advantage of liquidity. But because that liquidity comes with price transparency, public equity or REIT investing can be overlooked due to concerns about equity market volatility, as REITs react quickly to changing market conditions. It is true that public equity real estate can be more volatile than private real estate over short time frames. But public and private real estate returns are highly correlated over longer periods, such as those more akin to a typical private real estate investment holding period—say, five years.

Extending the holding period and lagging public market returns to better align with private real estate appraisals increases measured correlations noticeably (Exhibit 2). Understanding that public equity real estate, like private equity real estate, ultimately produces

Exhibit 1: Access Channels Across Four Quadrants of Real Estate



Source: LaSalle



Identifying potential that others may overlook

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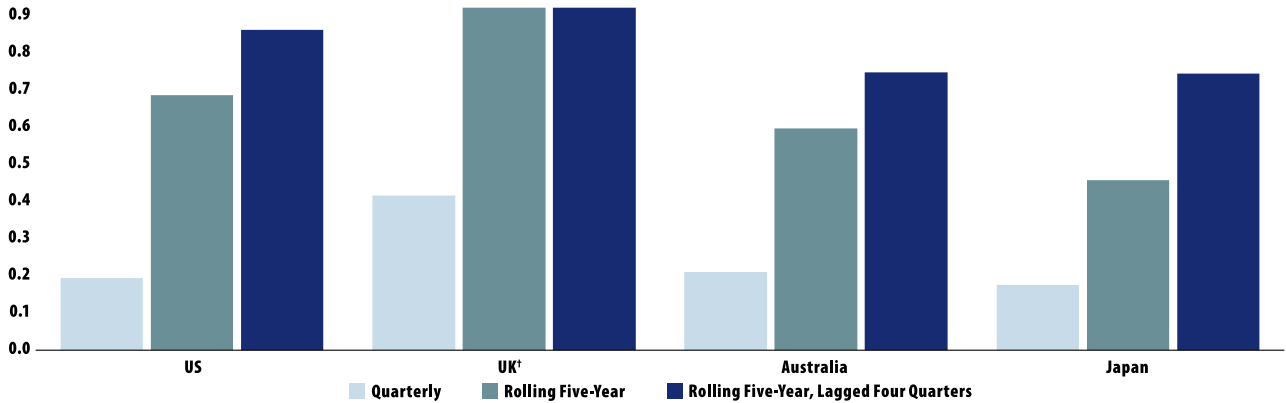
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Exhibit 2: Correlations Between Public and Private Real Estate Returns (1999–2024)*

1.0 = Perfectly Correlated



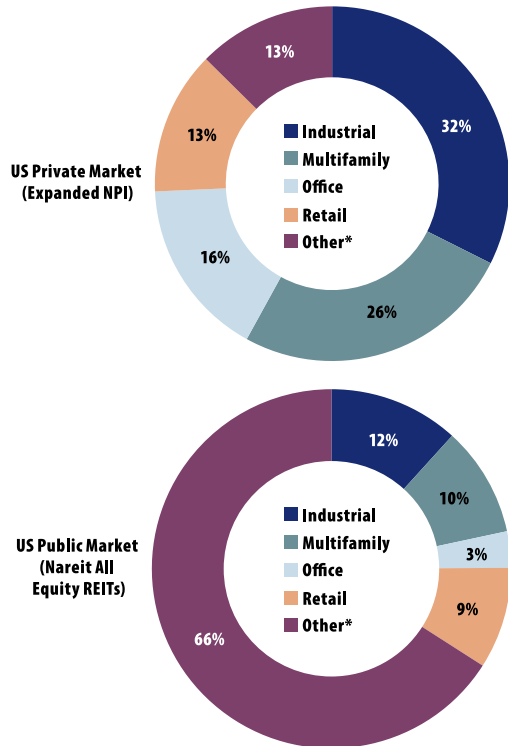
Sources: Bloomberg, NCREIF (NPI), MSCI, LaSalle Investment Management

Notes: Data are as of 2Q2024. No assurances are given that these trends will continue or materialize as expected. Nothing herein constitutes a guarantee or prediction of future events or results, and accordingly the information is subject to a high degree of uncertainty.

* Public real estate returns based on FTSE EPRA Nareit Developed Index. Returns from 1999 to 2024 (2Q2024).

† Lagged UK five-year correlation is expressed in terms of correlation without a lag because the appraisal process in the UK is relatively timely.

Exhibit 3: Composition of US Private and Public Markets



Sources: LaSalle, Nareit All Equity REITs Index, NCREIF

Notes: Public sector classifications use LaSalle Securities classifications. Data are as of June 30, 2024.

*Other includes cell towers, data centers, health care, life sciences, lodging, niche residential (single-family homes, student housing, manufactured housing), self-storage, specialty, timber, and triple net lease.

returns based on the performance of its underlying real estate supports the case for investing across both of them.

Public Equity Real Estate Sector Mix Has Diverged From Private

The composition of private and public equity real estate indices, after being initially aligned, has diverged materially in the past two decades (Exhibit 3). The lion’s share of private market indices remains dominated by the four traditional “food groups” of industrial, office, multifamily, and retail assets, with minimal, albeit increased, exposure to other “non-core” property sectors. In the public market, this makeup has shifted dramatically to the point that now only one-third of the public equity universe comprises those traditional property types.

The public market has seen a significant rise in “new economy” or specialty property types over the past two decades, with that shift accelerating in the wake of the global financial crisis. These new economy sectors include cell towers, data centers, health care, self-storage, triple net lease, and niche residential such as manufactured housing and single-family rental. The growth of these property types has been partially driven by robust fundamental dynamics that were supported by secular demand drivers, which differ from traditional real estate,

and the professionalization or roll-up of fragmented markets. Their typically outsized growth prospects have attracted capital and promoted institutionalization over time, progressing along what LaSalle calls the “going mainstream” continuum.

The public markets’ wide opportunity set affords an investor simple and quick access to an investment menu that has typically been challenging or inaccessible for private real estate investors, potentially complementing or augmenting their existing real estate allocations. LaSalle expects the real estate investment landscape to continue to evolve, and the public markets’ lead in that evolution offers a straightforward route to participating in an ever-expanding investment set.

Strong Case for Active Management in Public Real Estate

Persistent investment manager outperformance—i.e., the ability to add alpha—can be challenging to find consistently in many asset classes. An analysis of eVestment investment manager data shows evidence that this is not the case for listed real estate, with active REIT managers consistently outperforming passive approaches. An analysis of the competitive set of global listed real estate managers shows that those at the median consistently outperformed accepted benchmarks over the medium and longer term, notwithstanding shorter periods of underperformance. Further, the top quartile of that group has produced outperformance in the range of 200 basis points per annum, net of fees.

Several dynamics are present in the public real estate investing landscape that may help explain this dynamic. Unlike more-focused private equity investments, equity markets and their broader coverage can be dominated by investors that are nonspecialist and short-term focused, creating inefficiencies and opportunities for more-specialized investors. REITs are a small part of global equity markets (~4% of the MSCI World Index) but represent a large part of the global institutional real estate universe (~40% of institutional-owned real estate, based on LaSalle’s analysis of the real estate universe). An imbalance of focus and expertise can therefore create informational differences between specialists and generalists. Finally, active REIT managers appear

able to leverage their expertise to identify and take advantage of mispricing between fundamental fair value and share prices.

The Dawn of the Next “Golden Era” for REITs and Real Estate?

LaSalle’s recently published report *ISA Briefing: A New “Golden Era” for REITs and Real Estate?* highlights the challenging investment environment public and private real estate have faced in the period since the end of 2021, a “great tightening cycle” characterized by the rapid tightening of financial conditions. The report highlights that sentiment toward real estate in general has been weighed down not only by the higher interest rate environment but also by constrained bank lending, a barrage of negative headlines about commercial real estate, and REIT and private real estate underperformance relative to the broader equity market or other asset classes. Our analysis identifies previous “golden eras” for REIT performance that were preceded by similar dynamics.

Those golden eras were characterized by dramatic growth in the REIT market or outsized investment returns versus other asset classes or both.

- The savings and loan crisis spurred what is often considered the birth of the modern REIT era in the mid-1990s. During this period, the number of REITs increased by nearly 50%, and the market cap of that group grew nearly sevenfold.
- Following the dot-com bubble in the late 1990s, a period when REITs were significantly out of favor, the REIT market experienced a multiyear run of strong absolute performance in which it cumulatively outperformed broader equity markets by more than 300%.
- The period following the global financial crisis from mid-2007 to early 2009 saw the rise of dynamic new property sectors in the public market and another period of outperformance in which REITs led broader equities by 50%.

While each golden era was unique, LaSalle’s analysis found that each period was preceded by challenging circumstances with the common elements noted above, as well as an easing or a resetting of financial conditions. Although history does not repeat itself, it does often

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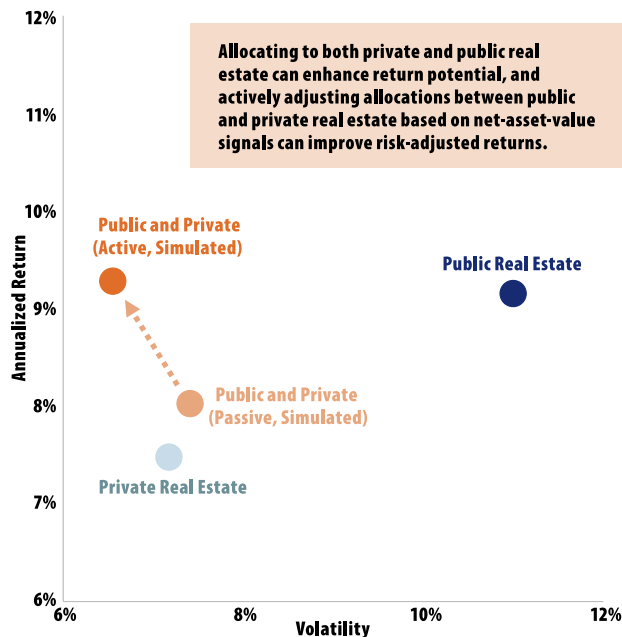
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Exhibit 4: Annualized Returns and Volatility of Portfolios of Public and Private US Real Estate



Source: LaSalle; June 2024

Notes: Backtested performance results have certain inherent limitations. Such results do not represent the impact that material economic and market factors might have on an investment adviser's decision-making process if the adviser were actually managing client money. Backtested performance also differs from actual performance because it is achieved through the historical simulation of model portfolios designed with the benefit of hindsight. Actual portfolio performance will be different from backtested performance as the portfolio managers exercise additional judgment in constructing an actual portfolio, in addition to the rebalancing utilized during the backtesting. Additionally, the performance of an actual portfolio has the potential to incur losses as well as earn profits and may include the deduction of advisory and custodian fees that were not incorporated in the backtesting.

Annualized Return: Annualized total return from Dec. 31, 1998, to June 30, 2024, using FTSE Nareit All Equity REITs Index for public real estate and NCREIF ODCE index for private real estate.

Volatility: Green Streets methodology—standard deviation of annualized rolling three-year returns.

Public and Private (Passive): This simulated portfolio demonstrates how a simple 25% to 75% allocation to REITs/private real estate can increase risk-adjusted returns. The portfolio allows for the REIT allocation to float within +/- 10% bands; i.e., weighting can range from 15% to 35%. This is a common strategy to reduce turnover and constant reallocation to maintain weights within the range as the market moves over time.

Public and Private (Active): This hypothetical back-tested return does not represent performance from actual trading of an account or a portfolio, and it is not a guarantee or representation of future results. Active return is based on a hypothetical portfolio with REIT weighting range of 0% to 50% determined by NAV P/(D) Z-scores, rebalanced quarterly with a one-quarter lag between signal and reallocation.

rhyme. The presence of all those elements in today's market environment, and the potential for concerns to flip to opportunities, may foretell the next REIT and real estate golden era.

Better Together

Investors can use the relationship between public and private equity real estate to their advantage. For larger institutions, public equity real estate provides an efficient way to access nontraditional property types and nondomestic real estate. Public equity real estate also has the potential to account for a meaningful portion of a core real estate allocation, particularly for small- and medium-sized institutions.

A simple allocation to public equity real estate is complementary to private real estate in that a combination of the two may generate higher risk-adjusted returns than either approach on its own, based on historical experience (Exhibit 4). Savvy investors may be able to go beyond this by using the leading nature of public equity real estate to mine for valuation signals and tactically play the two segments to their advantage. While a simple allocation can improve risk-adjusted returns, a tactical and active allocation can meaningfully enhance both absolute and risk-adjusted return profiles of an investor's real estate investment.

The lesson? Focusing on a single or only a few quadrants of real estate and not approaching the asset class holistically may lead to an underdiversified portfolio and leave notable upside on the table. ■

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