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ODCE ADOPTS AN ALTERNATIVE APPROACH

The availability of a reliable benchmark is often a cornerstone of a well-functioning institutional asset class.



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The CFA Institute defines a valid benchmark as one that is specified in advance, relevant, measurable, unambiguous, representative of current investment options, and complete. The availability of a reliable benchmark is often a cornerstone of a well-functioning institutional asset class.

By any stretch, the NCREIF Fund Index—Open End Diversified Core Equity (NFI-ODCE, or just ODCE) has been an excellent benchmark for institutional investors in private commercial real estate for decades. One reason ODCE is relied on so heavily is its lack of ambiguity. ODCE’s rigid inclusion criteria specify everything from leverage levels constituent funds can use to property types and more.

In the CFA Institute’s definition of a valid benchmark, though, the criterion “unambiguous” may be slightly at odds with other elements, such as “complete” and “representative of current investment options.” This is especially true for private real estate when contrasted with the way public real estate markets have developed over time.

In this article, we examine how core real estate benchmarks were developed, how they were used historically, and how they are evolving to better reflect today’s real estate universe. We think this can unlock strategy clues for the next decade of commercial real estate investing.

We examine how private core real estate funds, such as those in ODCE, are expanding into more property types. In our view, this expansion improves diversification within private real estate funds and, by extension, improves the relative value offered by ODCE funds and other private real estate vehicles.

Although more diversification is beneficial overall, we also believe it could cause the dispersion of performance to widen across core funds. This divergence is poised to create growing alpha opportunities for investors that can identify and select winning strategies and managers.

Development of Real Estate Indices

During the time public real estate investment markets were being established, advancements in measurement of privately owned commercial real estate were also being made. NCREIF was founded in the early 1980s as a nonprofit trade association that provided standardized, reliable performance data for private real estate investors. NCREIF became a market leader in closing the information



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Exhibit 1: Index Sector Allocations

	Nareit		ODCE		
	2010	2024	2010	2024	MIM 2034 Projection
Traditional Office	13.5%	5.0%	33.8%	17.2%	9.0%
Traditional Industrial	6.1%	12.1%	14.1%	31.7%	30.0%
Retail	26.8%	14.8%	24.9%	12.7%	15.0%
Shopping Center	8.9%	5.1%	11.2%	5.1%	9.0%
Regional Mall	15.8%	4.3%	12.9%	6.2%	2.0%
Freestanding	2.1%	5.4%	0.9%	1.4%	4.0%
Residential	15.4%	14.9%	24.0%	27.8%	28.0%
Apartment	14.7%	9.9%	24.0%	25.4%	18.0%
Manufactured Home	0.7%	2.2%	0.0%	0.3%	2.0%
Single-Family Home	0.0%	2.8%	0.0%	0.9%	5.0%
Student Housing	0.0%	0.0%	0.0%	1.2%	3.0%
Diversified	8.0%	1.9%	NA	NA	NA
Lodging/Resort	6.5%	2.9%	2.7%	0.2%	1.0%
Self-Storage	5.8%	7.3%	0.0%	4.3%	5.0%
Health Care	11.8%	9.9%	0.0%	4.8%	6.0%
Timberland	6.1%	2.4%	0.0%	0.0%	0.0%
Telecommunication	0.0%	12.6%	0.0%	0.0%	1.0%
Data Center	0.0%	9.4%	0.0%	0.9%	4.0%
Gaming	0.0%	3.3%	0.0%	0.0%	0.0%
Specialty /Other	0.0%	3.3%	0.5%	0.3%	1.0%

Sources: MetLife Investment Management, Nareit, NCREIF

Notes: Data are as of 2Q2024. NCREIF property-type definitions were adjusted for comparison to Nareit index.

gap that once hindered the flow of institutional capital into the sector. It is now the gold standard for performance measurement and benchmarking of US private commercial real estate.

ODCE is an index of core, perpetual life real estate equity funds that are diversified across US cities and, historically, across what have been considered the four traditional core property types—apartment, office, retail, and industrial.

ODCE comprises 25 funds with \$290 billion in gross assets under management as of June 30, 2024. Though it is heavily relied on as a benchmark, ODCE has sometimes been viewed as an overly rigid index. To be included in the index, fund managers are required to meet specific inclusion criteria. NCREIF’s original ODCE inclusion criteria, which were established in 2005, included (but were not limited to) these:

- **Property Types**—at least 80% of market value of real estate net assets invested in four traditional property-type sectors of office, industrial, apartment, and retail
- **Diversification**—no more than 65% of market value of real estate net assets in one property type or one region as defined by the NCREIF Property Index (NPI)
- **Leverage**—no more than 40% leverage
- **Life Cycle**—at least 80% of market value of real estate net assets invested in operating properties (no more than 20% in development)

NCREIF updated some of the original criteria in early 2019, such as lowering the maximum leverage from 40% to 35% and changing the property-type criteria from 80% of market value of net assets to 75% of market value of gross assets. However, the first criterion on property types was not revised in 2019 and has come under scrutiny in recent years, specifically how core

Exhibit 2: Revised ODCE Property-Type Inclusion Criteria

At Least 75% Must Be Invested in Core Sectors								
Industrial	Residential	Office	Retail	Other	Self-Storage	Land	Senior Housing	Hotel
Warehouse	Apartment	Central Business District	Strip	Data Center			Skilled Nursing	Limited Service
Manufacturing	Student Housing	Suburban	Street	Operating Land			Independent Living	Full Service
Specialized	Manufactured Housing	Secondary Business District	Mall	Entertainment			Assisted Living	
Flex	Single-Family Rental	Urban		Parking			Continuing Care	
Life Science		Life Science		Other				
No More Than 25% in Alternative Subtypes								

Sources: MetLife Investment Management, NCREIF; as of 2Q2024

property types are defined. If the index is meant to be a benchmark for core real estate, is it achieving its goal by focusing on definitions of traditional core property types that haven't changed since the 1980s? How far have these definitions diverged from what is occurring in public markets today?

REITs Help Redefine Core

Volumes of academic and industry literature have been written comparing REITs with private real estate. While suitability in institutional portfolios can be debated at length, REITs and major REIT indices haven't been subject historically to the same restrictive inclusion criteria as ODCE. Additionally, their strict reporting standards offer some version of a track record for private real estate investors to evaluate. Taken together, observing capital flows in public real estate markets provides a helpful crystal ball into where capital may flow into private real estate in the future.

Exhibit 1 shows that alternative property-type exposure in the Nareit property index is not a new phenomenon. As of 2010, alternatives made up more than a third of the index. Over the next 14 years, that number increased to around 60%, with sectors such as telecommunication, data center, self-storage, and a handful of others capturing market share.

ODCE's transition to alternative property types is not as far along, though significant changes have already occurred. As of the start of 2024, alternative property types and subtypes made up about 13% of the index, compared with 3% in 2010.

Despite the progress, ODCE's property-type allocation was beginning to look out of step with REITs by the mid-

2010s, likely because of outdated property-type definitions and lack of change in what constitutes a core property type.

Recognizing this need to adapt to current market conditions, NCREIF began considering in the late 2010s how ODCE should evolve. Superregional malls offered a useful comparison. The mall sector was considered core according to ODCE inclusion but not today, according to most industry participants.

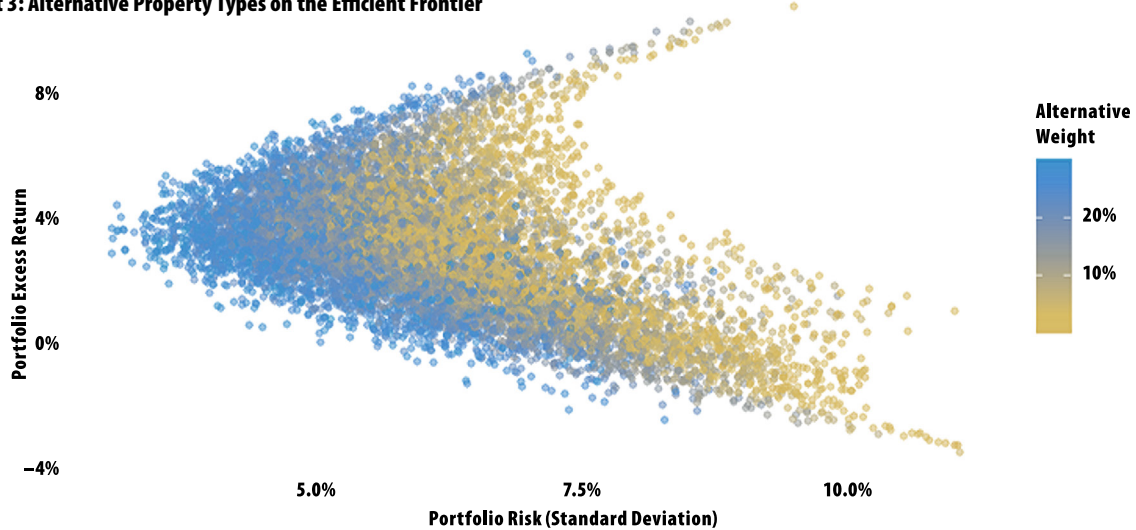
ODCE's Evolution

Leaning on signals from public markets, NCREIF began by formally updating property-type definitions in 2021 (Exhibit 2). The apartment sector is now more broadly defined as residential and includes subindices such as manufactured housing, student housing, and single-family rental. The office and industrial categories were broadened to include a bucket for life science. As we discussed, NCREIF also increased the allowable allocation to alternative property types such as hotels and parking garages, among others, from 20% to 25%.

Given the new inclusion criteria, an ODCE fund could theoretically have up to 50% of the portfolio allocated to what were historically considered alternative property types (25% in non-core property types and 25% in newly created subtypes of core property types).

It is hard to overstate the significance of this change. First, it widens the pool of opportunities available to ODCE fund managers, which is especially important given the challenges the mall and office sectors (which traditionally accounted for a large share of ODCE) have faced in recent years. As we will discuss, this change should also benefit risk-adjusted returns by offering the potential to increase sector diversification within funds and lower portfolio volatility.

Exhibit 3: Alternative Property Types on the Efficient Frontier



Sources: MetLife Investment Management, Nareit; as of 1Q2024

Finally and most important, this change shows that ODCE remains an effective benchmark by ensuring that the index is representative of investment options available to core commercial real estate investors today. In addition to updating property-type inclusion, NCREIF also adopted a governance change that specifies that the NCREIF board of directors must review the inclusion policy at a minimum of every three years to ensure industry alignment.

Looking to the Future

We expect that the availability of performance measurement data on a wider field of property types will accelerate the allocation of ODCE capital outside what have typically been considered core property types. MetLife Investment Management (MIM) forecasts that alternative property types will constitute around a quarter of ODCE in ten years.

In our view, alternative housing sectors such as single-family rentals, technology sectors such as data or life science, and self-storage will gain share. We expect most of the shift out of old core sectors to come from office. Office exposure was 36% of the index in 2010 and is now just under 20%. We expect that exposure to decline to around 10% over the next ten years. Office was falling out of favor even prior to the work-from-home revolution because of high capital expenditure needs and slowing demand growth.

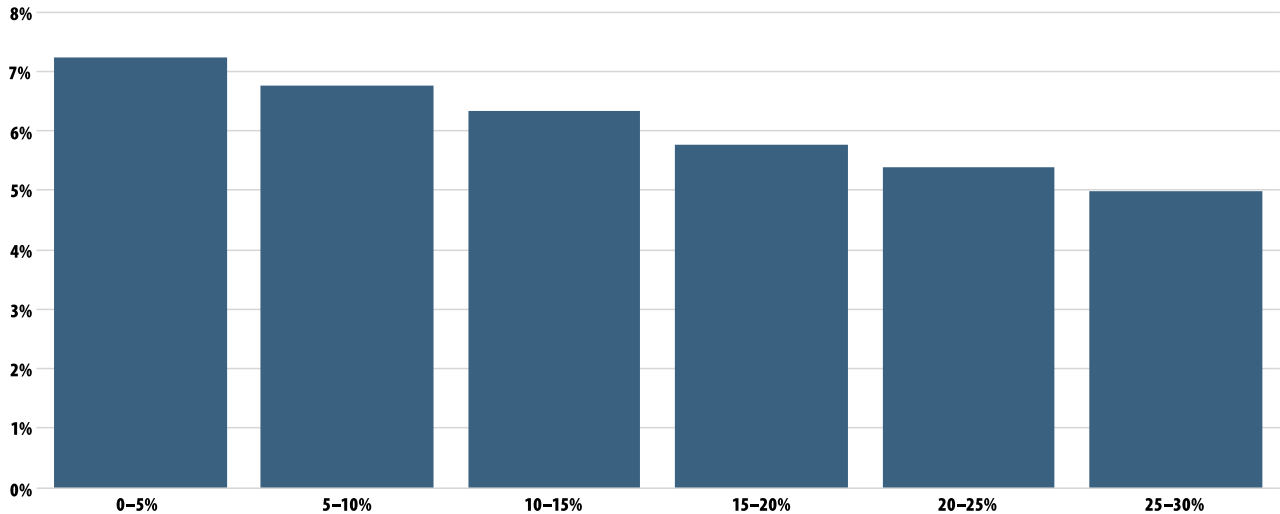
This sector rotation outlook is informed by shifting property-type allocations among public REITs. It is also informed by where we see opportunities for private real estate investors today, which often must compete with REITs for the same transactions and sometimes for the same investors. Last, we also considered how technology is shaping access to harder-to-reach sectors. Data and technology that can streamline the transaction process is particularly important for sectors with small transaction sizes, such as single-family rental, net lease retail, and tower. Technological advancements are also important for historically nontransparent sectors such as data center and seniors housing.

Strategy Implications of Evolving Benchmarks

A wider menu of property types offers the opportunity to improve portfolio diversification and thus risk-adjusted returns when included alongside traditional core sectors. Using data from the public real estate sector, which has a more complete performance history across most core and alternative property types, we can demonstrate how the inclusion of alternatives improves portfolio risk-adjusted returns.

Exhibit 3 analyzes excess return from the benchmark and excess return volatility of property sectors in the Nareit Equity REIT Index between

Exhibit 4: Portfolio Standard Deviation by Alternative Weight



Sources: MetLife Investment Management, Nareit; as of 1Q2024

2014 and 2023. Using this data, we created 10,000 portfolios of varying randomly selected weights. We capped alternative property-type exposure at 30% of any portfolio, and in the interest of representing opportunities available in the market today, we removed office from the analysis (historical office returns and volatility would unfairly drag down core sector returns because most core managers are not materially increasing office exposure today).

The analysis shows clear risk-adjusted return outperformance for portfolios that have larger allocations to alternative property types (represented by darker blue dots). These portfolios make up the efficient frontier, in which it is theoretically impossible to achieve better returns for a given level of risk.

It might be reasonably assumed that rapidly growing alternative sectors such as data center explain this result. However, alternative sectors such as hospitality and health care have underperformed the benchmark in recent years, and core multifamily and industrial have outperformed. There are, in fact, many modeled portfolios with low allocations to alternatives that have higher absolute returns.

We ascribe this phenomenon to the diversification benefits achieved by incorporating a broader spectrum of sectors with varying correlation coefficients. As

Exhibit 4 demonstrates, portfolio standard deviation (which accounts for correlations across property types) decreases as exposure to alternative property types increases.

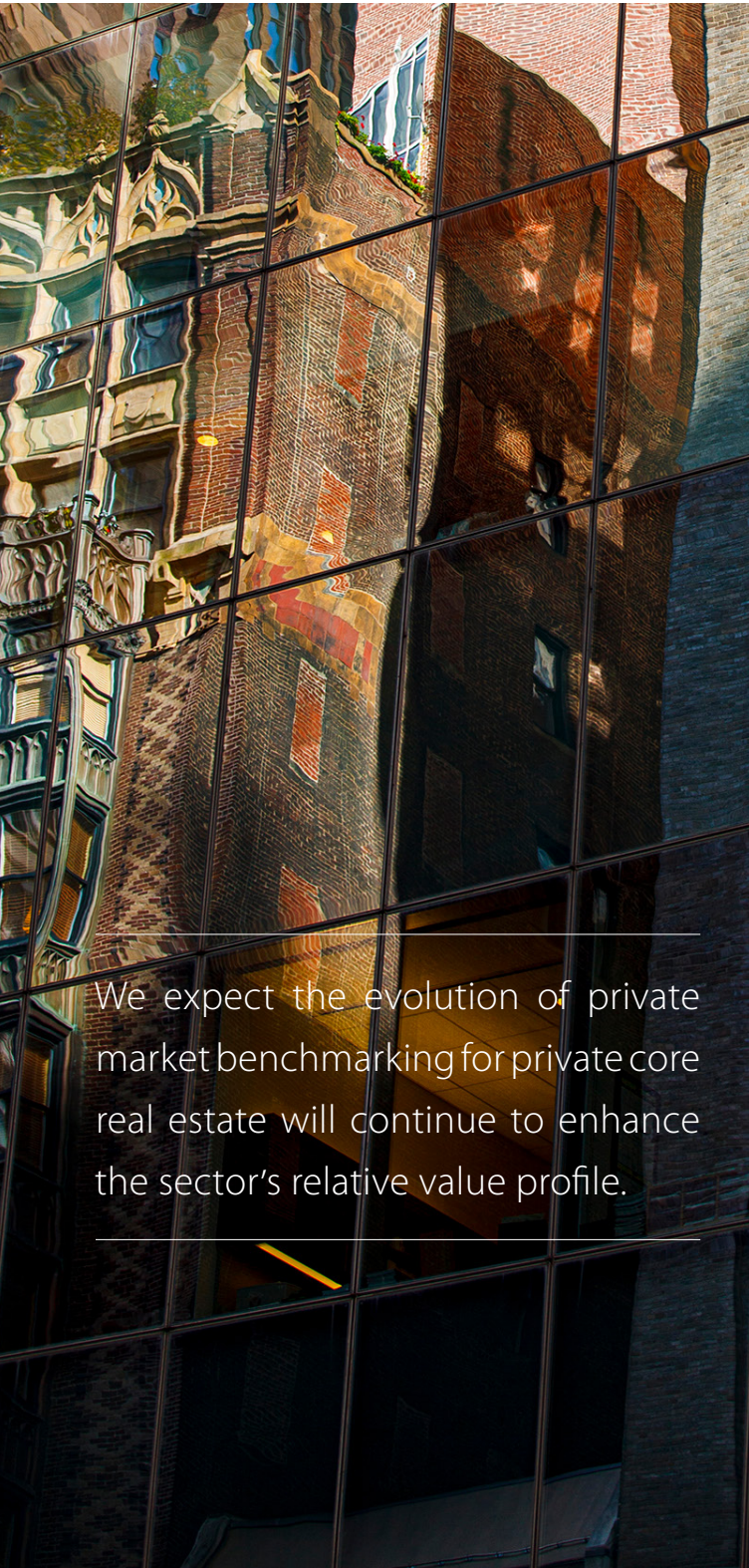
This leads to a counterintuitive yet compelling conclusion: integrating non-core sectors into a portfolio enhances its stability, effectively transforming the risk profile to resemble that of a more core investment. It also underscores that property-type designations don't always translate into portfolio-level designations.

The Future of Benchmarking

In our predicted future in which ODCE funds have larger exposure to historically non-core sectors, sector allocation, rather than asset selection, may define successful managers. This is partly a result of the increasing range of sector options for ODCE funds, likely leading to a wider dispersion of returns between the best and worst sectors.

Risk driven by asset selection may become more masked over time as sector allocation becomes a larger driver of performance. This is particularly important for larger funds for which individual asset selection risk may be nearly diversified away.

We recommend investors consider both managers' allocation strategies and the quality of asset selection



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within subindices of the NPI. For example, a manager may be outperforming simply because of an allocation to single-family rentals over traditional apartments, but are the best single-family rentals the market has to offer being selected, and are they being operated effectively? Subindices of the NPI may become as important as the headline index in the future for evaluating strategies and managers.

Conclusion

As investors reconsider their strategies for the next cycle, the role of major benchmarks, particularly ODCE, has come into focus.

The gradual shift toward alternative property types within ODCE, like trends observed in the REIT sector, suggests a more-inclusive and representative benchmark for core real estate investments. This transition, accelerated by advancements in data availability and technology, positions ODCE to better capture the breadth of opportunities in today's market.

We expect the evolution of private market benchmarking for private core real estate will continue to enhance the sector's relative value profile. However, the importance of manager selection will intensify, and the strategies surrounding sector allocation and asset selection will become more sophisticated. Ultimately, this shift will ensure that core portfolios remain resilient and competitive within an ever-evolving investment landscape, reaffirming their position as a foundation of institutional investment strategy. ■

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