

## How CRE Debt Can Boost Pension Fund Portfolios



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**“In constant pursuit of stable,** long-term returns, pension funds are increasingly turning to alternative asset classes as a means to diversify their portfolios and bridge funding gaps. One asset class that has garnered significant attention in recent years is commercial real estate (CRE) debt. According to the PREA Investment Intentions Survey, 81.1% of investors plan to increase their allocations to CRE debt investments over the next two years, citing the potential for portfolio diversification and attractive risk-adjusted returns.”<sup>1</sup>

Higher interest rates have bolstered the financial soundness of pension funds in two primary ways: by providing higher yields on newly issued bonds, thus improving their income profiles, and by reducing liabilities through a higher discount rate applied to future liabilities. This combination has led to improved funding ratios, which are expected to rise to 80.9%, according to Milliman.<sup>2</sup> However, even under Milliman’s optimistic scenario, the funding ratio will

reach only 86.2% by 2025, indicating that pension funds will continue to be underfunded (Exhibit 1).

In response, pension funds are actively seeking alternative investment strategies to bridge these gaps and meet their long-term obligations. In today’s higher interest rate environment, pension funds will shift more of their assets into fixed income investments because they can now earn higher yields. As a result, they are increasingly looking toward investments that share similar characteristics to bonds but can offer higher yields because these investments can help narrow their funding gaps.

### Enhanced Yield from CRE Debt

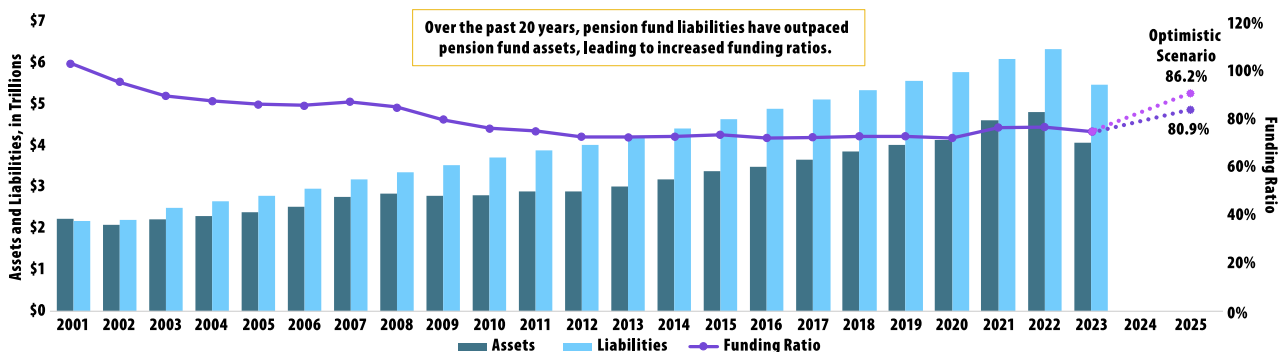
CRE debt has emerged as an attractive fixed income alternative for pension funds looking to fortify their investment portfolios. Its appeal lies in its potential ability to boost portfolio performance, through a

1. 2024 [Investment Intentions Survey](#), PREA. Investors refers to pension funds, insurance companies, sovereign wealth funds, and other investor types that are already invested in CRE debt.

2. [Milliman Pension Fund Index June 2024](#).

### Exhibit 1: US State and Local Pension Assets, Liabilities, and Funding Ratios

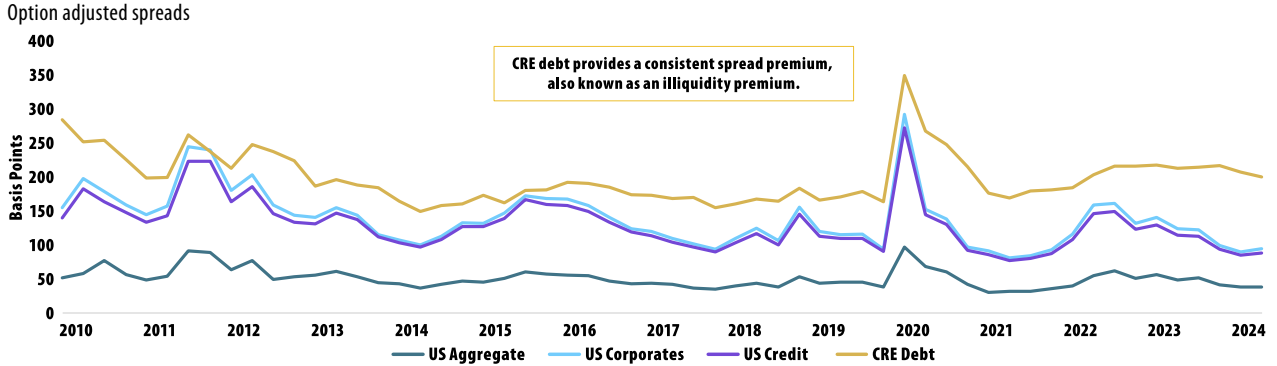
Higher interest rates bolster pension funding ratios, but gaps remain.



**Sources:** Public Plans Data, [Milliman](#), PGIM Real Estate

**Notes:** Data are as of August 2024. The Public Plans Data (PPD) contains annual data on the largest state and local pensions in the US. The sample spans fiscal years 2001 to 2023 and includes 229 plans (121 state run and 108 locally run), which account for 95% of state/local pension assets and members in the US. The PPD is produced by the Center for Retirement Research at Boston College in partnership with the MissionSquare Research Institute, the National Association of State Retirement Administrators, and the Government Finance Officers Association. Projections are based on the estimated funded status of the 100 largest US public pension plans, as measured by the Milliman 100 Public Pension Funding Index. Any projections or forecasts presented herein are as of the date of this article and are subject to change without notice. Actual data will vary and may not be reflected here.

**Exhibit 2: Enhanced Yields Through CRE Debt's Consistent Spread Premium**

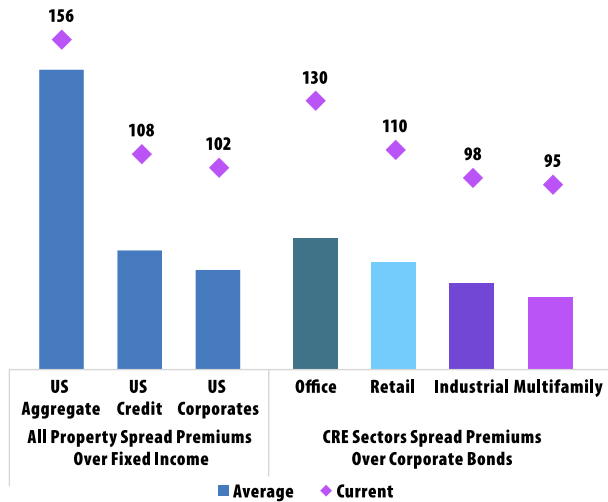


Sources: CREFC, Bloomberg, PGIM Real Estate

Notes: Data are as of August 2024. CRE debt spreads refers to bank balance sheet spreads for 60%–65% LTV, amortizing, ten-year, fixed-rate loans.

**Exhibit 3: Current CRE Debt Spread Premiums Versus Historical Averages**

Current CRE debt spread premiums are wider than historical averages.

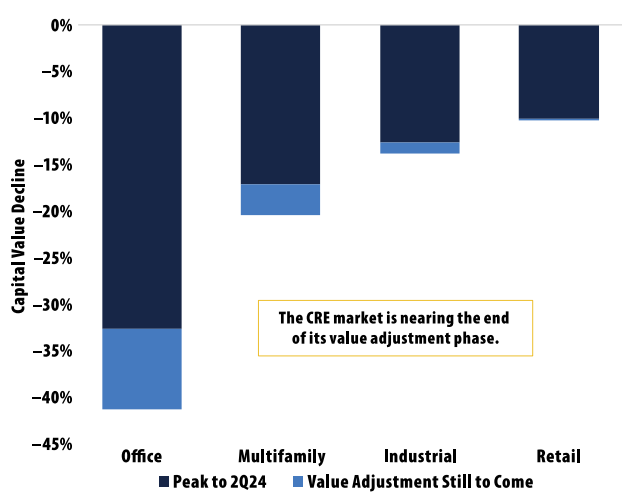


Sources: CREFC, Bloomberg, PGIM Real Estate

Notes: Data are as of August 2024. CRE debt spreads refers to bank balance sheet spreads for 60%–65% LTV, amortizing, ten-year, fixed-rate loans. The average is calculated over the period 1Q10 to 2Q24. Current refers to 2Q24.

**Exhibit 4: Expected Peak-to-Trough Value Loss**

The CRE market value reset is almost complete.



Sources: NCREIF, PGIM Real Estate

Notes: Data are as of August 2024. Value losses refers to the NCREIF Property Index, which tracks the unleveraged appraisal-based performance of core institutional property markets in the US.

combination of stable cash flows, higher yields, and diversification benefits but with manageable risks.

Regular interest payments provide a predictable income stream, similar to those of traditional fixed income investments, which can help pension funds meet their obligations to retirees. However, what sets CRE debt apart is its potential for higher yields, primarily because of the illiquidity premium and the complexities of the market's direct origination model.

This illiquidity has earned CRE debt a yield premium over corporate bonds averaging 60 basis points (bps) since 2010 (Exhibit 2) and with some variation across CRE sectors (Exhibit 3). Today, this premium is much higher, at 102 bps, as the CRE market undergoes a value reset, which is nearing completion (Exhibit 4).<sup>3</sup> This spread premium, which is available at origination, is

3. "2024 Global Outlook: Changing the Narrative," PGIM Real Estate, May 2024.



# The real alternative to alternatives

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Investment in farmland:

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- benefits from favorable long-term demographics to drive demand

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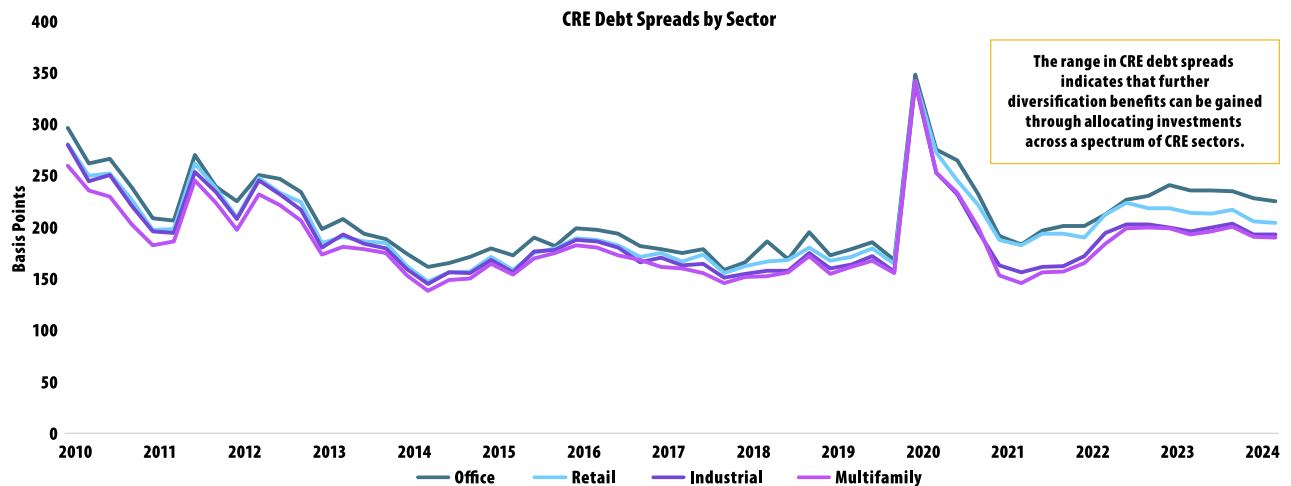
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**Exhibit 5: Diversification Benefits Through Allocating Across CRE Sectors**

**Sources:** CREFC, PGIM Real Estate

**Notes:** Data are as of August 2024. CRE debt refers to bank balance sheet spreads on 60%–65% LTV, amortizing, ten-year, fixed-rate loans.

further bolstered by the potential to earn additional income through origination, servicing, and prepayment fees. These fee streams contribute to the overall income premium of CRE debt.

However, the illiquidity that drives these higher yields also increases liquidity risk. Therefore, pension funds must carefully manage this aspect because it could pose difficulties if rapid access to capital becomes necessary. As such, pension funds need to manage this illiquidity and carefully select investments that will suit their risk, return, and liquidity objectives.

### Diversification Benefits from CRE Debt

From a total return perspective, CRE debt has outperformed other major fixed income asset classes, reflecting both the income delivered and changes in market value. It boasts higher annual returns and lower volatility. This combination explains why CRE debt has delivered Sharpe ratios nearly twice those of other fixed income indices,<sup>4</sup> making CRE debt an attractive option for those seeking to optimize risk-adjusted returns.<sup>5</sup>

With a correlation of less than 100% to other fixed income investments, CRE debt offers diversification benefits to fixed income portfolios. Pension funds can enhance these benefits by allocating investments across various CRE sectors, including office, retail, industrial, and multifamily properties<sup>6</sup> (Exhibit 5).

By doing so, pension funds can effectively mitigate the impact of market volatility in any single sector. This strategy helps construct a more resilient portfolio that is better equipped to withstand economic headwinds and capitalize on potential growth opportunities.

Furthermore, from a risk management perspective, CRE debt has experienced less severe and shorter-lived maximum drawdowns compared with other fixed income counterparts.<sup>7</sup> This characteristic helps mitigate potential losses during periods of market turmoil.<sup>8</sup>

### Depth and Breadth of the CRE Debt Market Size

The CRE debt market constitutes a substantial segment of the US debt market. As of the first quarter of 2024, the total commercial and multifamily mortgage market reached approximately \$4.7 trillion in outstanding mortgages, making it comparable in size to the nonfinancial corporate bond market (Exhibit 6).

Within the CRE market, new debt originations can offer loans with varying durations, secured by different property types across diverse locations. Additionally, the

4. Past performance is not a guarantee or a reliable indicator of future results.

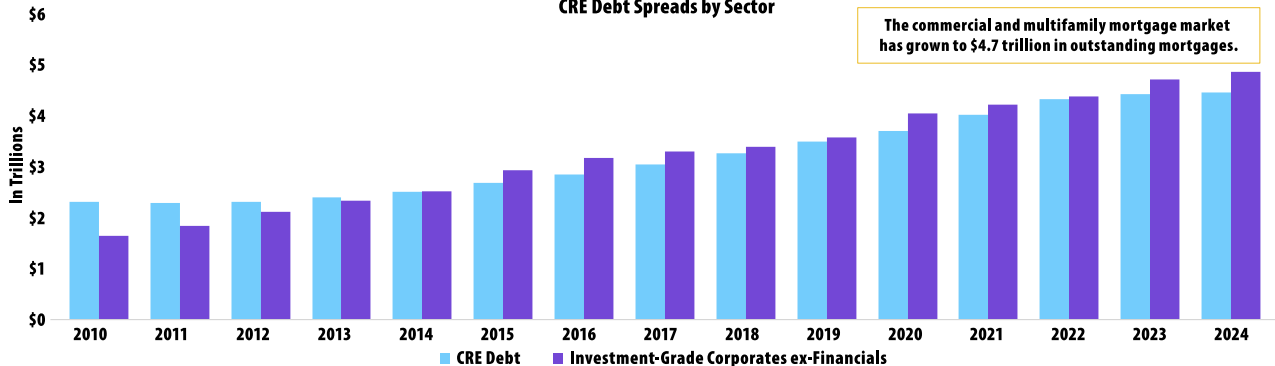
5. "Four Compelling Reasons to Diversify With Private Real Estate Credit," PGIM Real estate, June 2023.

6. Diversification does not assure a profit or protect against loss in declining markets.

7. No investment strategy or risk management technique can guarantee returns or eliminate risk in any market environment.

8. Henri Vuong, "Stability and Resilience in Uncertain Times: The Strategic Role of Core Real Estate Debt in Fixed Income Portfolios," *PREA Quarterly*, Winter 2024.

**Exhibit 6: CRE Debt Market Size Comparable to Nonfinancial Investment-Grade Corporate Bonds**  
**CRE Debt Spreads by Sector**



Sources: Mortgage Bankers Association, Bloomberg, PGIM Real Estate; as of August 2024

underlying tenancy of the collateral spans a wide range of credit profiles, further enhancing diversification.

Despite its private nature, the CRE debt market offers considerable depth and breadth to provide significant diversification potential, enabling pension funds to strategically allocate capital to assets that align with their investment objectives.

### Is Risk Mis-Priced?

CRE debt spreads are currently trending wider than historical norms, while loan-to-value ratios (LTVs) are low relative to history. This raises the question, Is risk mis-priced?

Wider spreads typically reflect increased risk perception, but they also indicate the potential for higher returns. Meanwhile, the lower LTVs indicate reduced risk exposure for lenders and a larger equity buffer to protect against potential losses. This scenario creates an unusual opportunity in which investors can potentially earn attractive spreads while taking on lower levels of risk than the spreads might suggest.

In essence, the market appears to be offering a risk-return profile that is more favorable to lenders than usual. This misalignment between perceived risk (as reflected in spreads) and actual risk (as indicated by LTVs) suggests that risk is currently mis-priced.

### On the Rebound

Recently, CRE spreads have started to tighten because of expectations that the Federal Reserve will cut interest rates soon. Lower interest rates would ease financing and valuation pressures, promoting rental growth and value rebounds across most CRE sectors. The anticipated reset

of the CRE markets is expected to conclude this year, with a subsequent rebound driving positive credit migration, thereby enhancing the credit quality of CRE debt portfolios.

### Balancing Opportunity and Risk

The inclusion of CRE debt in pension fund portfolios is not without risks. Pension funds should approach the CRE debt market with disciplined credit analysis and a solid understanding of real estate fundamentals. Rigorous due diligence and a thorough evaluation of each investment opportunity are essential for managing risk and ensuring the suitability of CRE debt investments. Factors such as property type and location, tenant quality, and loan structure must be carefully assessed to align investments with the specific objectives and risk tolerance of each pension fund.

If these risks are managed effectively, the potential benefits of CRE debt for pension funds are clear. With the ability to generate stable cash flows, offer attractive risk-adjusted returns, and provide portfolio diversification, CRE debt can boost pension fund portfolios in exchange for liquidity. By carefully selecting and managing CRE debt investments, pension funds can enhance their income profiles while maintaining a prudent approach to risk management, thereby helping to narrow their funding gaps. ■

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