Why the Current Real Estate Reset Demands Patient, Active Investing

Commercial real estate values have fallen in recent months due to rising costs of capital and higher interest rates. While property price declines have moderated in line with the drop in 10-year U.S. Treasury yields since their late October highs, some investors nevertheless wonder if 2023 might be a year when they should avoid real estate investments entirely.

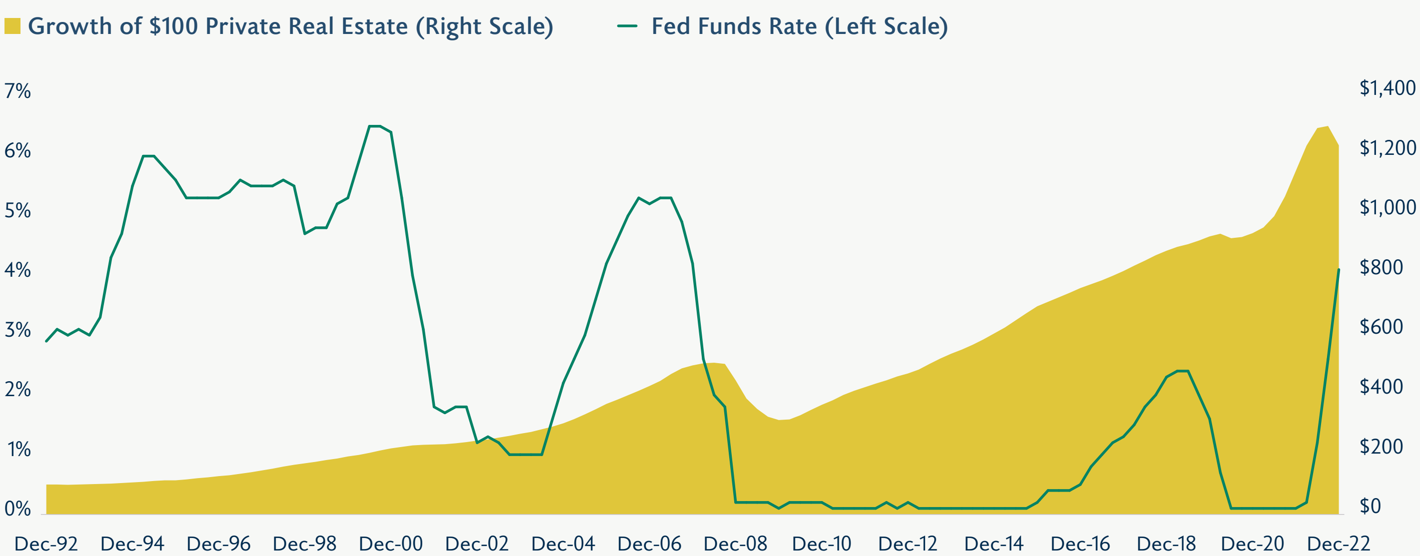
We argue that could be a mistake: We believe an actively managed approach to real estate, having an exposure to a combination of private market assets in strong locations with attractive employment centers, demographics, and both senior rated fixed and floating rate debt securities can help optimize investor's portfolios by providing potential income, diversification and inflation protection, as occurred over the past few volatile years in both real estate and financial markets.

As shown in **Figure 1**, real estate has generated attractive long-term returns over varying interest-rate environments; suggesting that this could be a potential long-term buying opportunity. While certain commercial property values are adjusting with the new realities of a changing financing environment, long-term fundamentals for certain sectors, like rental housing, continue to show secular strength.

Figure 1

Private Real Estate Has Generated Strong Long-Term Returns Over Multiple Rate Environments

U.S. Core Real Estate Returns vs. Federal Funds Rate, 30-Years, Ended December 31, 2022



As of December 31, 2022.

Source: Bloomberg

The NCREIF ODCE (Open-End Diversified Core Equity) index is a widely used benchmark for core open-ended real estate funds. The Diversified Core Equity style typically reflects lower risk investment strategies utilizing low leverage and generally represents equity ownership positions in stable U.S. operating properties diversified across regions and property types. Indexes are unmanaged and cannot be purchased directly by investors.

Timing Markets is a Fool's Errand

Given our belief that attempting to time markets is a fool's errand, we contend that allocating throughout the full market cycle (particularly when values have declined) can help compound long-term returns. Today, many property types still enjoy strong fundamentals, making it crucial to acquire the *right* assets at the *right* prices. As Oaktree Capital founder Howard Marks wrote in his book *The Most Important Thing*, "Investment success doesn't come from 'buying good things' but rather from 'buying things well.'" At the same time, we believe it is crucial, especially during times of dislocation, to engage a manager that has a track record of increasing net operating income through hands-on operational expertise.

We view the current reset of valuations as an opportunity to selectively deploy capital at higher yields after the past 12-18 months, when we took a very pragmatic approach to evaluating asset purchases. In many cases during that period, we felt that asset prices had reached untenable levels, not supported by growth prospects. Instead, we saw more attractive opportunities within real estate credit, especially floating-rate debt, where we felt cash flows could grow more quickly as interest rates rose.

We expect the reset in valuations could present some compelling opportunities in the coming months to acquire high-quality real estate assets at more attractive prices compared to recently. Anecdotally, we have already witnessed some motivated buyers of high-quality, income-producing assets.

Increased Need for Operational Expertise

These conditions are a compelling time for active managers of real assets to put capital to work. Brookfield has significant resources, scale and on-the-ground real estate specialists scouring the environment for motivated sellers of high-quality assets.

With the end of quantitative easing and ever-decreasing interest rates, we don't think real estate investors can rely as heavily on appreciation from cap-rate compression, compared with recent history. Instead, as interest rates and rent growth return to normalized levels, there will be increasing importance on driving net operating growth from an operational perspective. That requires expertise in property management and in sales/leasing. We believe experienced real estate managers with a track record of driving returns from the ground up are best positioned to deliver positive outcomes for clients.

IMPORTANT DISCLOSURES

All investing involves risk. The value of an investment will fluctuate over time, and an investor may gain or lose money, or the entire investment. Past performance is no guarantee of future results.

As an asset class, private credit is comprised of a large variety of different debt instruments. While each has its own risk and return profile, private credit assets generally have increased risk of default, due to their typical opportunistic focus on companies with limited funding options, in comparison to their public equivalents.

Because private credit usually involves lending to below investment grade or non-rated issuers, yield on private credit assets is increased in return for taking on increased risk.

Brookfield Asset Management Inc. ("Brookfield") completed a 62% acquisition of Oaktree Capital Group, LLC ("Oaktree"), on September 30, 2019. Each of Brookfield Oaktree Wealth Solutions LLC and Brookfield Public Securities Group LLC is a wholly owned subsidiary of Brookfield.

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