The Alts Institute

Real Estate and Bonds: A Complementary Pairing

Many investors have pared back their real estate allocation and shifted toward bonds this year, motivated by rising interest rates and a desire to maximize current income. We believe that investors should not perceive real estate as an alternative to fixed income, but rather as an allocation that can offer numerous potential benefits as part of a well-diversified portfolio.

When added to a portfolio that includes bonds, real estate can potentially provide:

- strong diversification benefits
- effective protection against inflation
- potentially enhanced real returns via a combination of income *and* capital appreciation.

Strong Diversification Benefits

Real estate can add diversification benefits to a bond portfolio. As shown in **Figure 1**, total returns generated by the two asset classes for the past 20 years suggest a symbiotic relationship where each can act as a portfolio diversifier for the other. The relationship appears to hold true across U.S. Treasuries, as well as U.S. investment-grade and high-yield instruments.

Figure 1: Real Estate Has Provided Diversification Benefits to Fixed Income Returns

	Broad U.S. Market	U.S. Treasuries	U.S. Investment Grade	U.S. High Yield
Correlation of U.S. Real Estate Returns to Fixed Income	-0.23	-0.12	-0.28	-0.20

Table shows sample correlation[1] regression statistics of quarterly total returns of U.S. real estate vs. various U.S. fixed income indexes for the 20-year period ended June 30, 2023. Broad U.S. Market represented by ICE BofA U.S. Broad Market Index, U.S. Treasuries by ICE BofA U.S. Treasury Index, U.S. Investment Grade by ICE BofA US Corporate Index, U.S. High Yield by ICE BofA High Yield Index, U.S. Real Estate by NFI-ODCE Index. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment.

Source: Bloomberg, National Council of Real Estate Investment Fiduciaries, Brookfield analysis, as of June 30, 2023.

That diversification makes intuitive sense because real estate encompasses a wide range of sectors with different sensitivities to the economic cycle, ranging from hotels and apartments to data centers and warehouses. Rents are influenced by such variables as location-specific supply/demand imbalances, capital improvements at specific properties, and regional economic growth differences. Irrespective of the economic cycle, we believe well-managed, quality properties in attractive markets can perform well in good and challenging times. So, real estate can help diversify a portfolio.

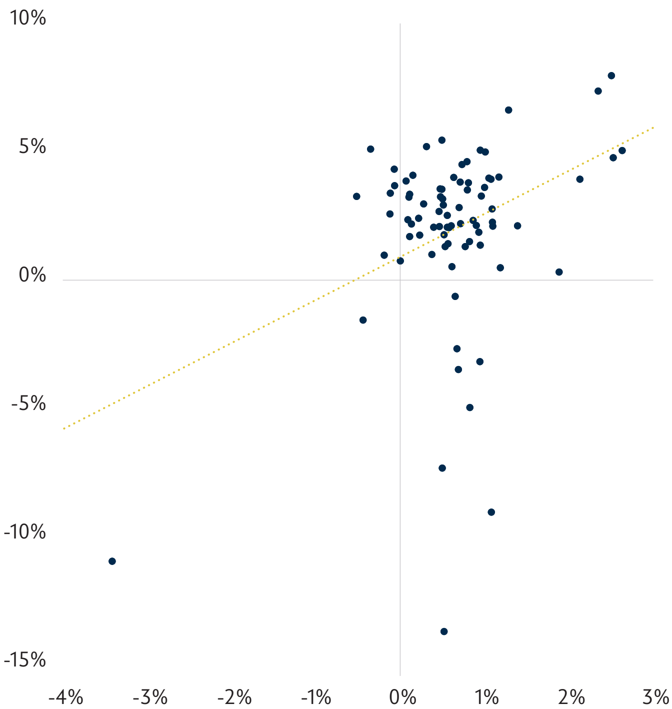
Diversification does not assure a profit or protect against loss in declining financial markets.

Effective Inflation Protection

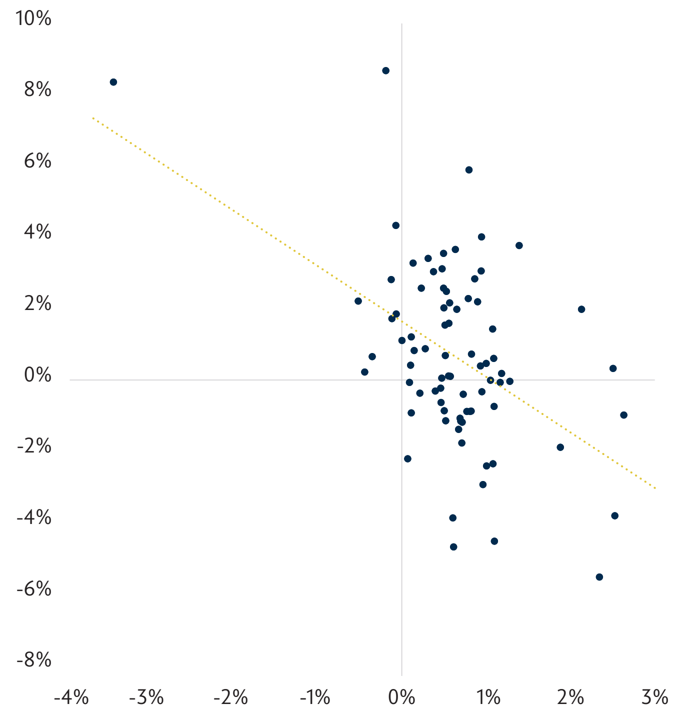
Real estate may be an effective counterweight to inflation because property owners can raise rents to offset rising prices. **Figure 2** shows the relationship between real estate and inflation on the left, and U.S. Treasury bonds and inflation on the right. The upward sloping line for real estate indicates that historically, real estate investors have experienced positive total returns when inflation has increased, helping to offset the traditional negative correlation between bond returns and inflation.

Figure 2: Real Estate Has Historically Provided Inflation Protection

Quarterly change in U.S. CPI Index vs. NFI-ODCE Index total returns



Quarterly change in U.S. CPI Index vs. U.S. Treasury Bond Index total returns



Past performance does not guarantee future results. Private U.S. real estate represented by NCREIF Fund Index – Open End Diversified Core Equity (NFI-ODCE), U.S. Treasuries by ICE BofA U.S. Treasury Index. Indices do not reflect the impact of transaction costs, management and other investment-entity fees and expenses or the costs associated with raising capital or being a public company, which lower returns. They are shown for illustrative purposes only and do not represent the performance of any specific investment.

Source: Bloomberg, National Council of Real Estate Investment Fiduciaries, as of June 30, 2023.

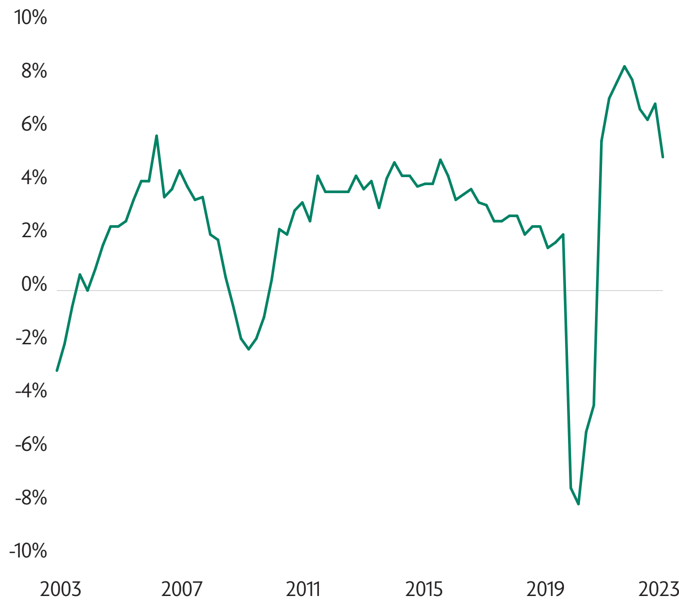
Please refer to important information, disclosures and risks at the end of this material.

Potential Enhanced Total Returns

The potential for real estate capital appreciation is driven by investors' ability to boost net operating income (NOI). Driving rent growth and controlling operating costs can be key to growing asset values. It can also help institutional-quality real estate investors to consistently grow same-store NOI growth over time (**Figure 3**), and has increased long-term capital appreciation.

Real estate's combination of income and capital appreciation potential can help improve long-term returns for investment portfolios that include significant bond holdings. **Figure 4** shows the total-return profile of private U.S. real estate, U.S. equities, international equities and U.S. fixed income over two decades. Over that period, real estate delivered higher income than bonds and, with capital appreciation, produced a return profile that also beat international equities and came close to matching U.S. equity returns.

Figure 3: Same Store Net Operating Income – Percentage Change Over Four Quarters

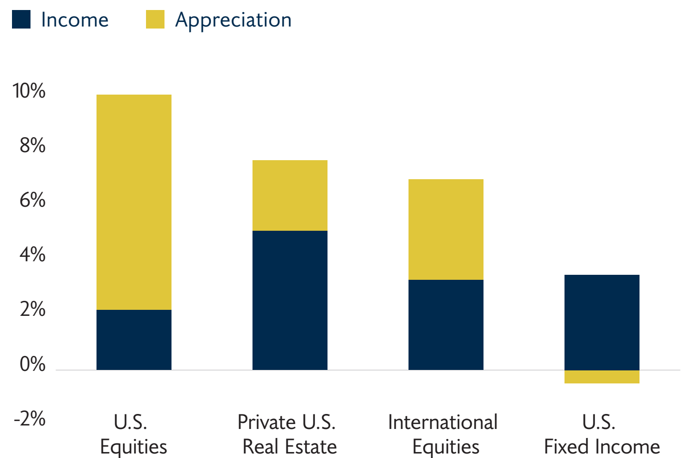


Past performance does not guarantee future results. Same store net operating income data represented by companies in the FTSE Nareit All Equity REITs Index, a free-float adjusted, market capitalization-weighted index of U.S. equity REITs. Constituents of the index include all tax-qualified REITs with more than 50% of total assets in qualifying real estate assets other than mortgages secured by real property.

Source: Nareit, as of June 30, 2023.

Figure 4: Capital Appreciation Potential Aims to Boost Real Estate's Total Return

Total 20-year annualized return for period ended June 30, 2023



Past performance does not guarantee future results. Total returns are comprised of income returns – which consist of interest, distributions or dividends generated by an asset or security; as well as appreciation returns, which consist of the change in the market value of an asset or security. Private U.S. real estate represented by NCREIF Fund Index – Open End Diversified Core Equity (NFI-ODCE), U.S. equities by S&P 500 Index, international equities by MSCI EAFE Index and U.S. fixed income by Bloomberg U.S. Aggregate Index. Indices do not reflect the impact of transaction costs, management and other investment-entity fees and expenses or the costs associated with raising capital or being a public company, which lower returns.

Source: Bloomberg, National Council of Real Estate Investment Fiduciaries, as of June 30, 2023.

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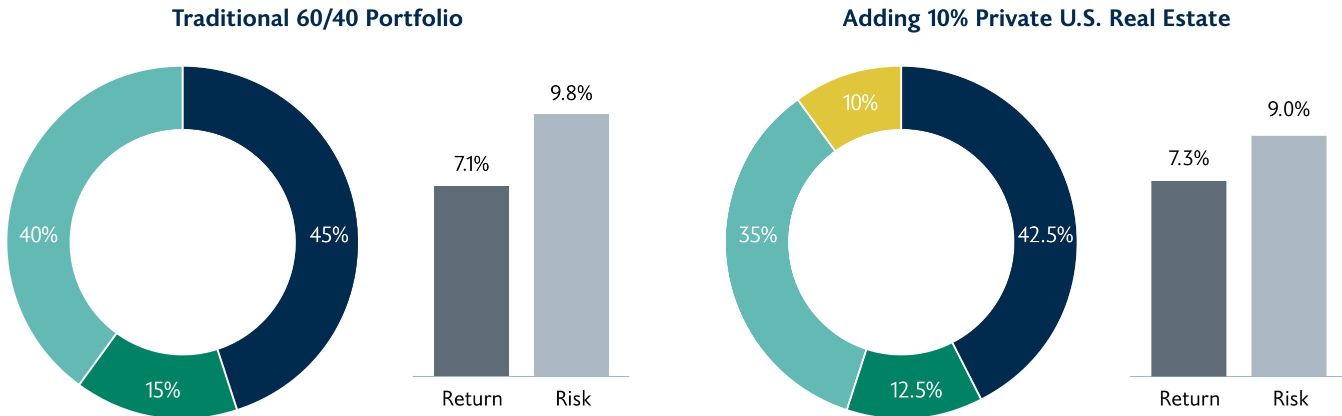
The Right Balance of Real Estate and Bonds for Long-Term Gains

We believe that the intrinsic characteristics of real estate make an allocation to the asset class an attractive complement to core bond holdings. While the past year or more has been a particularly challenging time for real estate as an asset class, we believe that over a long-term horizon, adding exposure to real estate can bring the potential for diversification benefits, protect against inflation and enhance total returns.

Figure 5 shows the impact of adding a 10% allocation to real estate to a hypothetical portfolio consisting of 60% equities and 40% bonds (drawing equally from each). Adding real estate boosted returns and lowered risk.

Figure 5: Adding Private Real Estate to a Traditional Portfolio Increased Returns, Lowered Risk

Trailing 20-year risk and return for period ending June 30, 2023



Past performance does not guarantee future results. Total return and risk as measured by standard deviation of quarterly returns for 20 years ending as of June 30, 2023, of a hypothetical portfolio as displayed of private U.S. real estate represented by NCREIF Fund Index – Open End Diversified Core Equity (NFI-ODCE), U.S. equities by S&P 500 Index, International Equities by MSCI EAFE Index and U.S. fixed income by Bloomberg U.S. Aggregate Index. Indices do not reflect the impact of transaction costs, management and other investment-entity fees and expenses or the costs associated with raising capital or being a public company, which lower returns. The indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment.

Source: Bloomberg, National Council of Real Estate Investment Fiduciaries, data as of June 30, 2023.

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Endnote

[1] Correlation measures how two investments move in relation to each other. A correlation coefficient of 1 indicates a perfect positive correlation, meaning that they move in the same direction by the same amount. A coefficient of -1 indicates a perfect negative correlation, meaning that they have historically moved in the opposite direction. A key benefit of a portfolio with low correlation among its various assets is reducing the volatility of overall returns.

A word about risk

Equity securities may fluctuate in response to news on companies, industries, market conditions and general economic environment.

Bonds are subject to interest rate risk. When interest rates rise, bond prices fall; generally the longer a bond's maturity, the more sensitive it is to this risk.

Investments in real estate related instruments may be affected by economic, legal, or environmental factors that affect property values, rents or occupancies of real estate.

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Index definitions

The Bloomberg U.S. Aggregate Bond Index is a broad-based benchmark that measures the investment grade, U.S. dollar denominated, fixed-rate taxable bond market.

The ICE BofA U.S. Broad Market Index measures the performance of U.S. dollar-denominated, investment grade debt securities, including U.S. Treasury notes and bonds, quasi-government securities, corporate securities, residential and commercial mortgage-backed securities and asset-backed securities.

The ICE BofA US Corporate Index tracks the performance of U.S. dollar denominated investment-grade rated corporate debt publicly issued in the U.S. domestic market.

The ICE BofA US High Yield Index tracks the performance of US dollar denominated below investment grade corporate debt publicly issued in the US domestic market.

The ICE BofA U.S. Treasury Index measures the performance of U.S. dollar-denominated sovereign debt issued publicly by the U.S. government.

The MSCI EAFE Index is an equity index which captures large and mid cap representation across Developed Markets countries around the world, excluding the U.S. and Canada.

The NCREIF Fund Index - Open End Diversified Core Equity (NFI-ODCE) is a capitalization-weighted, gross of fees, time-weighted return index that measures performance of the largest open-end commingled funds pursuing a core real estate investment strategy.

The S&P 500 Index measures the performance of large-cap U.S. equities and includes 500 leading U.S. companies, covering approximately 80% of available market capitalization.