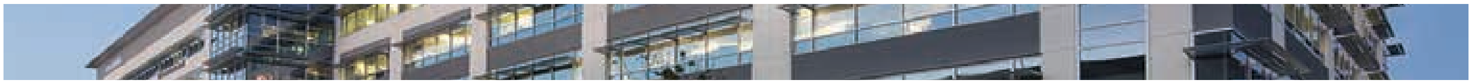

Investing in a Low Interest-Rate Environment

At the KBS Investor event in September 2018, everyone was talking about how commercial real estate (CRE), especially income-producing office buildings, would fare in a rising interest-rate environment.

At the time, the 10-year U.S. Treasury had a yield of 3.1%. Many global investors and bond traders were convinced that interest rates were headed to at least 3.5% and maybe even 4.0% in 2019.

Well, the experts were wrong, and they missed the 2019 bond market rally and decline in yields. Instead of the 10-year U.S. Treasury moving from 3.1% in September 2018 to an anticipated 3.5% by December 2018, the 10-year U.S. Treasury made a massive move down to a yield of roughly 1.5%.

As of this writing, there is no indication those yields will move up any time soon. In fact, all signs point to the Federal Reserve reducing rates by at least another 25 basis points. Some investors might want to believe we've reached the bottom, but much of Europe is facing ZERO interest rates and, in a few countries, we are seeing negative interest rates.

Low rates might be good for borrowers, but they play havoc with an investor's portfolio. To achieve the returns they need, investors around the world are being forced to take on more risk simply to achieve yields that risk-free Treasuries and other fixed-income instruments used to offer. Some are moving into investment-grade corporate bonds, currently averaging 2.9%.[1] Others are moving up the risk spectrum into high-yield BB or CCC bonds, yielding between 3.8% and 12.1%.[2] As they look at these available public credit market opportunities, sophisticated investors soon discover that although the yields are higher than Treasuries, they are not commensurate with the risk being taken. Those willing to look at alternatives, especially income-producing real estate assets, are finding more balance in their risk/reward assessments. The risks found in these less volatile, income-producing assets, which target attractive cash yields and distributions for investors, are what many investors are moving to for their investment portfolios.

A FIXED-INCOME ALTERNATIVE

Knowledgeable investors are taking a serious look at investment into income-producing commercial real estate. They like that the cash flow is produced by assets with a much better credit and balance sheet structure compared with high-yield bonds, where corporate cash flow is not nearly as predictable as longer-term lease payments and rental income.

Investors and advisers like that they can evaluate the validity of that cash flow on an asset-by-asset basis. Commercial office buildings filled with good-quality tenants, for example, can be expected to continue to produce significant cash flow year over year. In addition, by analyzing other factors unique to real estate, such as location and attractiveness of the building, investors can make their own evaluations and assumptions for potential long-term return.

WHAT IF RATES RISE?

At some point, interest rates will have to rise from the current very low levels. If 10-year rates manage to climb back up to the 3% level they were a year ago, bond investors would lose capital. But what happens to income-producing CRE assets in that environment?

The key to using CRE to augment a fixed-income investments portfolio is the term "income-producing." Existing buildings, with high occupancy and a stable tenant mix, will tend to produce consistent, predictable income for investors, which can be compared to different types of bonds, credit and yield instruments. Other types of CRE, such as new development and rehab deals, can be very good long-term investments, but they have very little cash flow to distribute in their early years. They also carry much greater risk when compared to an established, fully leased office asset, and therefore cannot take the place of fixed-income investments.

Rising interest rates affect the cost of debt, but most income-producing CRE assets already have their fi nancing in place. If rates rise, the effect will be minimal to the cash fl ow of those buildings. .

One caveat: Investors need to be looking at private real estate to obtain these benefits. Those who look to publicly traded REITs as a substitute for private real estate will likely find their shares losing value as investors sell REIT shares in a short-term rising rate environment.

Finally, if rates are rising, it is likely caused by the Federal Reserve tightening monetary policy for fear of inflation. Inflation is actually helpful to most CRE and is indicative of a stronger economy. This is very different than bonds or publicly traded yield instruments, which do not perform well when interest rates rise.

BOTTOM LINE

Private, income-producing CRE can be a profitable and predictable investment in these uncertain times, when no one really knows which direction interest rates are headed. Long-time sponsors of private CRE funds have seen it all and can work with advisers and investors to find the appropriate substitute when bonds are no longer the answer.

1. Moody's Seasoned Aaa Corporate Bond Yield, Federal Reserve, Sept. 5, 2019   2. US High Yield Effective Yield, Bank of America Merrill Lynch, Sept. 5, 2019

FOR MORE INFORMATION

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