



Real estate alternatives: Changing the role of real estate within an institutional portfolio

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OPINION PIECE. PLEASE SEE IMPORTANT DISCLOSURES IN THE ENDNOTES.

Executive summary

Since commercial real estate became an institutional asset class in the late 1970s and early 1980s, office, industrial, retail and apartments — the traditional four — have comprised the majority of institutional real estate investors’ portfolios. The U.S. institutional real estate benchmark, NCREIF Fund Index–Open End Diversified Core Equity (“NFI-ODCE”), had an 85% allocation to the four traditional property types as of December 2020.

While the allocation to the alternative real estate property types has grown during the last 15 years, in our view, it remains too low considering the myriad of benefits the alternative property types offer vis-à-vis the traditional four. These benefits include:

- Higher historical and future risk-adjusted returns
- Enhanced portfolio diversification which became exceedingly clear during the COVID-19 pandemic as the alternative property types exhibited resiliency in values
- Lower capital expenditures as a percent of net operating income (“NOI”)
- More ways for investors to express views on structural changes affecting demographics, healthcare and technology

We anticipate the alternative property types will play a more significant role in institutional real estate portfolios in the coming decades. Additionally, we expect real estate benchmarks and portfolios will transform in the coming years as more of the alternative property types are incorporated into institutional real estate portfolios. More importantly, before the alternative property types become mainstream real estate investments, there is a window of opportunity in the next several years for investors to capture the alpha associated with being ahead of the consensus in incorporating the alternative property types into portfolios.

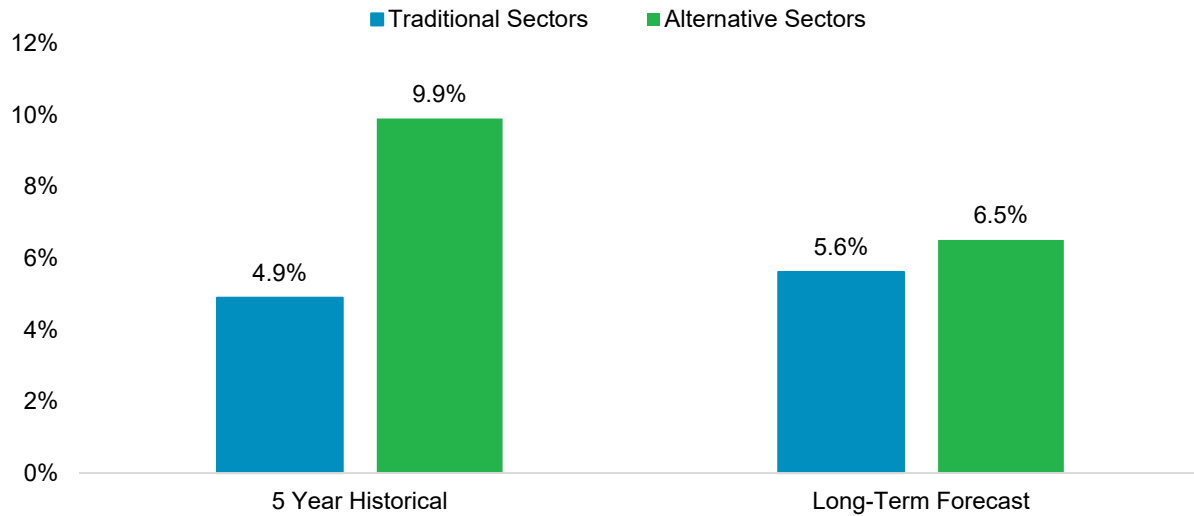
Performance and diversification attributes

The alternative property types have historically provided higher risk-adjusted returns than their traditional counterparts. Nuveen Real Estate research’s proprietary analysis suggests the alternative property types will continue to have higher risk-adjusted returns going forward relative to the traditional property types (Figure 1). The historical and potential future outperformance of the alternative property types is critical for investors seeking ways to either beat their benchmark or to generate enhanced returns.

In our analysis, strong future NOI growth and lower volatility (risk) will be the primary drivers of the alternative property types’ higher projected risk-adjusted returns. Using Green Street’s Commercial Property Price Index (“CPPI”), the historical volatility of the alternative property types has been below the all-property average (2007-2020). According to this analysis, manufactured homes, single-family rentals, medical offices and most healthcare-related property types had lower volatility than the all-property average. Meanwhile, lodging, malls and offices exhibited the highest historical volatility. Going forward, we anticipate the alternative property types will maintain their strong income growth and low volatility because their demand drivers are driven by structural changes, such as a rise in the digital economy and rising healthcare consumption, and less by economic growth.

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Figure 1: Historical and forward risk-adjusted returns¹

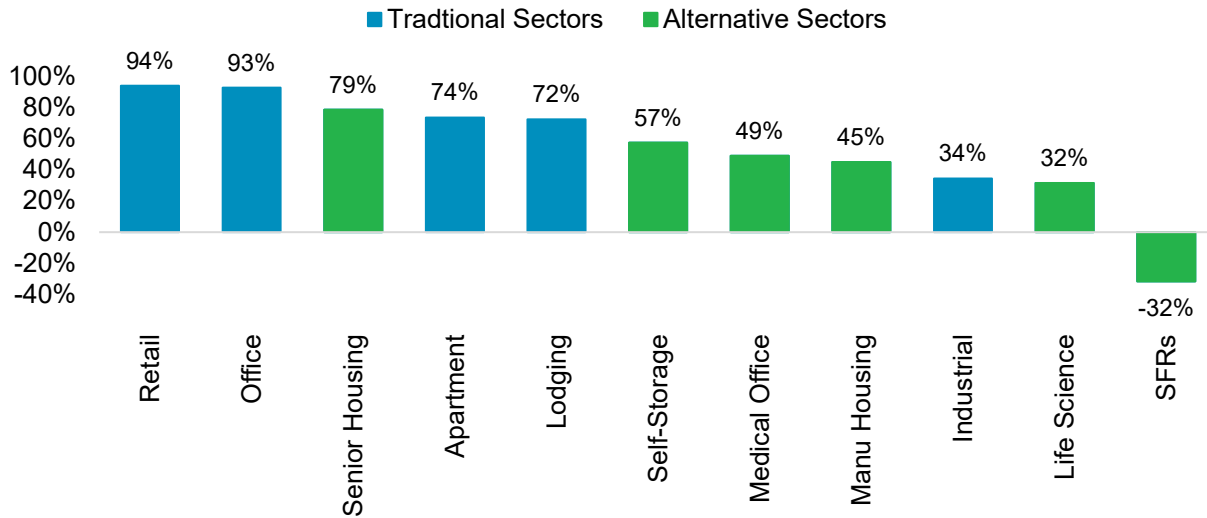


Source: Green Street; Nuveen Real Estate

In addition to having higher historical and future risk-adjusted returns, the alternative property types are also less correlated to each other and to real estate values overall. As shown in Figure 2, the returns of the four traditional property types tend to be highly correlated to real estate values overall. Specifically, retail and office values are highly correlated to each other and to real estate values more broadly. Meanwhile the returns of the alternative property types tend to be less correlated to real estate values overall, providing enhanced portfolio diversification. The correlation among the alternative property types is lower since their returns are driven by secular tailwinds and less tied to economic activity than many of the traditional sectors.

¹ Expected return is not a prediction, projection or guarantee of future performance and there can be no assurance that such return will be achieved.¹ Expected returns and historical performance period as of March 2021. Alternative property types include single-family rentals, manufactured housing, self-storage, life science, medical office, senior housing, data centers, and cell towers.

Figure 2: Sector 5-yr correlation to green street's all property average

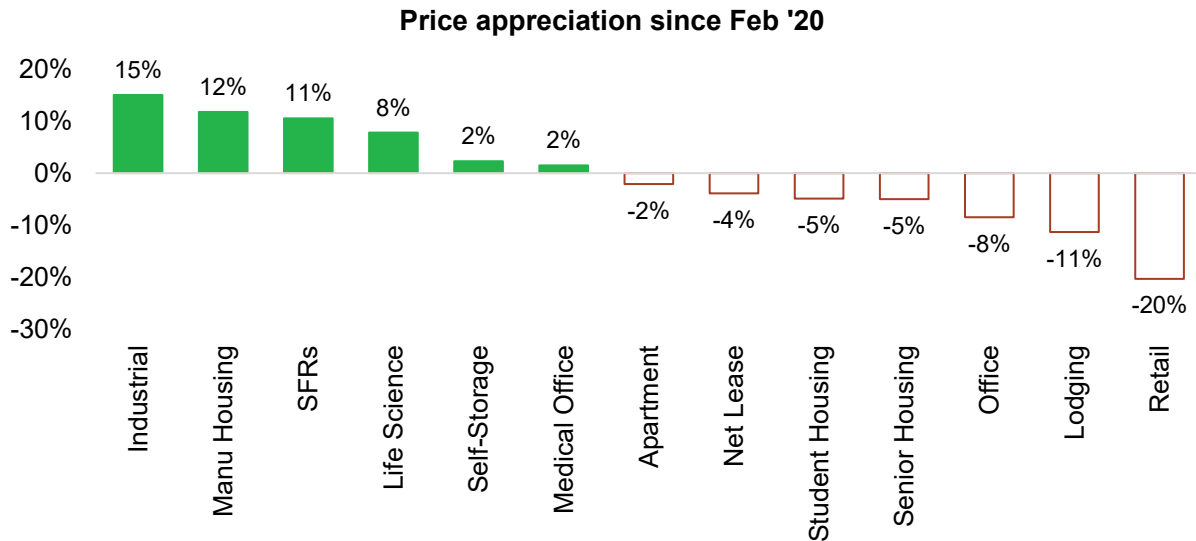


Source: Green Street; S&P Case-Shiller; Nuveen Real Estate

Note: The correlations are based on Green Street's CPPI and were calculated from April 2016 to April 2021.

The low correlation between the alternative property types and many of the traditional property types became especially apparent during the COVID-19 pandemic. As measured by Green Street's CPPI, the alternative property types saw their values either decline less than most of the traditional property types or saw their values rise. Meanwhile, many of the traditional real estate property types, except industrial, saw their values fall (Figure 3). The pandemic-induced recession, while unique in nature, demonstrated how the demand drivers for the alternative property types rely less on economic growth and more on structural themes such as the rise of the digital economy (data centers), rentership (single-family rentals) and life-saving drug developments (life science).

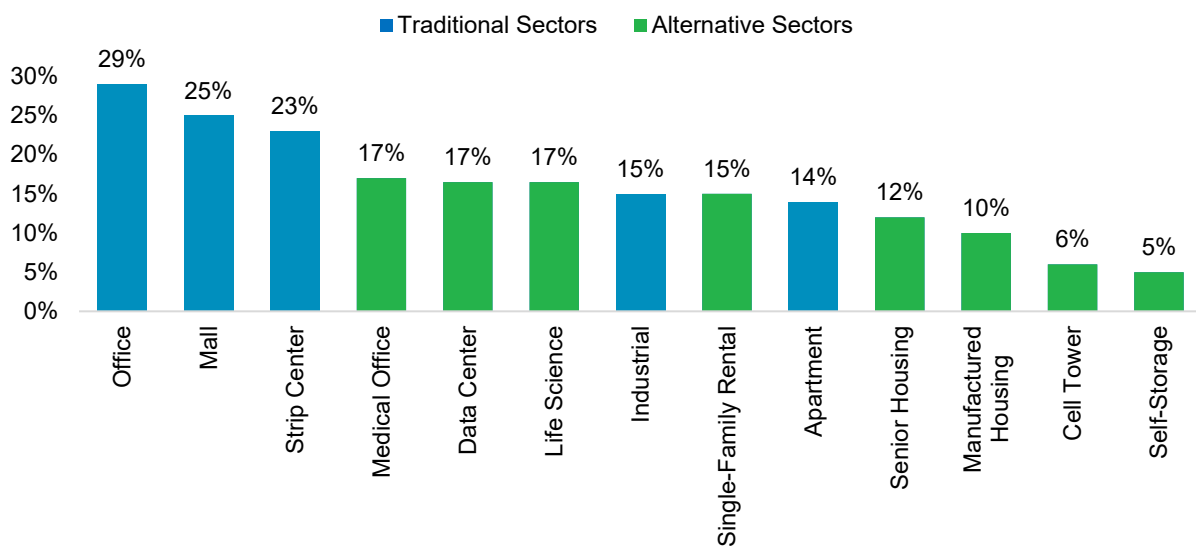
Figure 3: Change in value since February 2020 by property type



Source: Green Street; S&P Case-Shiller; Nuveen Real Estate

One component of the alternatives' outperformance is the reduced need for capital expenditures relative to the traditional property types (Figure 4). Going forward, the amount of capital expenditures for some of the traditional property types, such as office and retail, could potentially move higher than what is shown in Figure 4 as both property types undergo a transformation in how people shop and utilize office space in a post-COVID world.

Figure 4: Capital expenditures as a percent of net operating income



Source: Green Street; Nuveen Real Estate

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A wider array of real estate investment options

While often overlooked, the wide array of real estate alternative property types provides investors with the ability to execute upon their views on key thematic or structural changes that could not otherwise be expressed through an allocation to the four traditional property types. By way of example, acquiring warehouses is one way to capitalize on the rise of the digital economy since many warehouses derive their demand from rising online shopping; it can also be expressed through an allocation to cell towers, data centers and cold storage.² Further, investors’ beliefs around a continued shift towards renting can certainly be expressed through the acquisition of apartments. It can also be articulated by buying single-family homes, manufactured homes and self-storage.³

Figure 5: Universe of real estate alternative property types

| Property type | | |
|-----------------------------|------------------|-------------|
| Single-family rental | E-gaming studios | Casinos |
| Manufactured housing | Cold storage | Cell towers |
| Self-storage | Skilled nursing | Billboards |
| Life science | Net lease | Shipyards |
| Medical office | Ground lease | |
| Senior housing | Studios | |
| Data centers | Hotels | |

Source: Nuveen Real Estate

The alternative property types have garnered more institutional investor attention since the onset of the COVID-19 pandemic due to their resiliency. Yet, in our view, institutional real estate portfolios are under-allocated to the alternative property types. This under-allocation creates a missed investment opportunity given the numerous portfolio benefits the alternative property types provide. Specifically, these property types offer, relative to most of the traditional property types, higher risk-adjusted returns, enhanced portfolio diversification, lower capital expenditures and additional ways to execute on convictions around structural trends and key thematic.

During the next decade, we believe institutional real estate portfolios will transform as investors gain more familiarity with the alternative property types and starting increasing their allocations to them. Before the alternative property types become a part and parcel component of institutional real estate portfolios, investors should consider adding the alternative real estate property types to their portfolios as a way to drive potential outperformance and to generate enhanced returns.

² Cold storage is tied to the digital economy as more households choose to buy groceries online.

³ The primary reason for renting self-storage is moving.

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