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Looking beyond 60/40 portfolios

Real Assets Adviser recently sat down with **Jeff Hertz,** SVP, head of national sales — advanced planning at Cantor Fitzgerald Asset Management, to talk about commercial real estate investment opportunities in today's unsettled economic climate. Following is an excerpt of that conversation.

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**— Jeff Hertz, SVP, Head of National Sales — Advanced Planning
Cantor Fitzgerald Asset Management**

The past three years have been quite distinctive for commercial real estate, with the COVID-19 pandemic onset in 2020, historic transaction volumes in 2021, and the current environment of high inflation and rising interest rates. Which has been the most challenging to invest in?

The answer hinges on the type of investor. 2020 was challenging for the average investor as access to capital and the ability to travel were severely limited. In addition, title and registrar offices were often closed, which meant that many real estate transactions, including time-sensitive 1031 exchanges, couldn't be executed. Institutions with established lending relationships fared better. However, there were a couple months of peak uncertainty in the spring when the world was waking up to the potential implications of the pandemic when not much of anything took place.

Consistent with record transaction volumes in 2021, we were highly acquisitive, especially with multifamily properties, but we also disposed of properties that had achieved their business plan. While cap rates continued to compress in 2021, borrowing costs remained accretive, and real estate fundamentals remained healthy, especially for multifamily, industrial and life science property types.

Maybe because we are living in it right now (recency bias), but I would argue the 2H of 2022 is the more challenging environment institutionally.

And what presents the most significant challenges currently?

The 10-year treasury yield was 1.63 percent at the start the year. The yield curve has severely inverted, and yields have more than doubled and now hover in the high threes, which means borrowing costs are in the fives or even sixes. The same concerns about availability and cost of capital that are driving broader market uncertainty persist with real estate.

The positive backdrop for real estate, especially for our focus sectors, is that overall fundamentals remain strong. Demand for housing continues to grow while new supply continues a decade-long drought. Real estate owners are lower levered and better capitalized. The U.S. banking system is in a much stronger position than 15 years ago. Risk assets are repricing, some quicker than others. Our experience through past cycles, access to deal flow, and ability to transact as a no- or low-levered buyer position us nicely in this market environment.

For traditional investors in a stock/bond portfolio, this whole year has been a challenge. How do you see those investors' desire for portfolio alternatives, such as real estate, changing?

Through Q3, on an inflation-adjusted basis, a 60/40 portfolio is on track to have its worst year in history. We continue to see investors and advisers looking for solutions outside of stocks and bonds. They are realizing that real estate and other alternatives, from infrastructure to private debt, don't have to be speculative and can instead serve as additional core holdings, helping to insulate portfolios from equity volatility while potentially delivering attractive returns. For example, class A multifamily properties in larger markets with diverse employment profiles and economic drivers have delivered excellent returns even throughout the pandemic. Similarly with infrastructure, the asset class has held up well, the fundamental backdrop is intact, and the inflation-linked pricing inherent to the asset class has further benefited investors. Of course, real assets and private markets don't only go up in value. The key is that they strive to deliver a complementary return profile with a different sequence of returns, smoothing out overall volatility in a portfolio.

How does an investor add real estate to their portfolio?

Investors have never had more choices. The democratization of real estate, often overused, has really arrived. The same thing is happening in other sectors, such as infrastructure and private debt, and it won't stop there as high-net-worth investors are realizing what institutional investors discovered decades ago, and now, high-net-worth investors can also access these important strategies from best-in-class managers. Publicly traded REITs, semi-liquid real estate companies, '40 Act–structured companies (e.g., interval funds and other private-placement vehicles) provide optionality, each with its own positive and negative attributes. Like structure selection, investors have access to multiple strategies within each asset class. For example, core, highly occupied, income-producing real estate using moderate leverage is a more conservative approach with a moderate return profile compared with development or opportunistic strategies that might take more risk targeting higher-octane returns.

What sort of expectations should investors have when investing in real estate? How will returns vary, depending on the structure of investments?

I am not sure the structure is the primary driver of return expectation as much as strategy. Core real estate, considered lower on the risk/return spectrum, has historically delivered a high single- to low double-digit return, with close to half of the return coming from current income, usually highly tax advantaged. Risk and return elevate from there as you move from core to value-add to opportunistic.

Where structure matters is with fees, economies of scale, diversification, transparency, and alignment between management and investors, among other considerations. Thorough due diligence and working with a trusted adviser are important.

Is real estate appropriate for nearly every investor?

We believe real estate plays a critical role in portfolio construction, but that doesn't necessarily mean private funds are the only way to get exposure. For example, anyone who owns an S&P 500 index fund has exposure to about 35 traded REITs. However, as an investor's net worth grows and the need for 100 percent liquidity declines, most advisers would advocate for including private real estate and other private asset classes in portfolios. If you look at high-net-worth investors, having 20 percent or more allocated to privates is not uncommon. In addition to asset-allocation considerations, there are also event-driven situations leading to an increased use of alternatives. For example, when an individual is selling an investment property or they are selling a business with a capital gain.

A major focus of your platform is tax-advantaged investments in the 1031 and opportunity zone (OZ) space. How do you see investors engaging with these investments in the current environment?

First, we see the best advisers spending more and more time getting educated on these important solutions and, in turn, educating their clients. While a 1031 exchange or an OZ investment might not always be the right recommendation, in this case, ignorance is not bliss. If a client is selling a property, it's critical to understand the differences between paying tax, doing a 1031, using a 721 exchange, an OZ investment, or even a combination of multiple strategies. We see advisers dramatically elevating their value proposition when fully equipped with all options for high-net-worth investors.

Most of our readers are familiar with the 1031 exchange; can you elaborate on a 721 exchange?

Like IRC Section 1031, a 721 exchange is part of the tax code, IRC Section 721. Like a 1031, a 721 provides for tax deferral on an investment property. However, where a 1031 involves swapping investment property for an investment property (a "like-kind" exchange), a 721 is the tax-deferred exchange from an investment property for operating partnership units of a REIT.

The 721 might appeal to someone who is seeking increased diversification or who doesn't want to continue to have to worry about completing 1031 exchange after 1031 exchange indefinitely, especially given the political uncertainty of Section 1031.

And where do opportunity zones fit in when discussing the sale of property?

When an investor is selling a property, a 1031, a 721 and an OZ should be considered. Several qualitative and quantitative factors will help determine what is ultimately best for the client. It's also important to remember that when selling personal property, such as a home or a vacation property, a 1031 and 721 can't be utilized, while an OZ can.

When it comes to investment real estate, typically the cost basis, amount of debt, risk tolerance, life expectancy, ownership structure and the income needs of the investor are the primary drivers of whether an OZ, 1031, 721 or simply paying taxes is the preferred outcome. For example, if you bought a piece of land for $3 million with no debt, and a few years later sold the land for $4 million. If you did a 1031 exchange with the proceeds, you must invest all $4 million into the replacement property to defer 100 percent of taxes. With an OZ, only the $1 million of gain must be invested allowing you to pocket the $3 million of basis tax free.

Sometimes, 1031s, 721s, OZs and paying some tax can be combined to optimize the outcome based on the investor's needs.

Are there other things that Cantor does or focuses on that sets you apart a bit from the other participants?

We focus on mitigating risk for our clients. We do that in several ways. Number one, we have a diversified portfolio of assets in multiple markets, which avoids, in many cases, the binary risk of relying on the success of a single project, asset class, or market. Number two, we focus on core asset classes, predominantly multifamily, net lease, industrial and life science on the real estate side, and across the spectrum in infrastructure. No one can unerringly predict the future, but we focus on long-term secular trends that we expect will continue to drive long-term demand, whether at the market level or at the asset-class level. Third, we conservatively utilize debt, both in the type as well as the amount. Last, our 77 years in financial services across many cycles and environments provide a deep level of experience. Taken together, these aspects of our strategy have served us well in controlling risk for our clients while providing access to institutional commercial real estate and infrastructure strategies in multiple vehicles.