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Harrison Street Insights Core Real Estate is out of "Alternatives"

July 2023

Self Storage



Life Sciences



Medical Office



Senior Housing



Student Housing

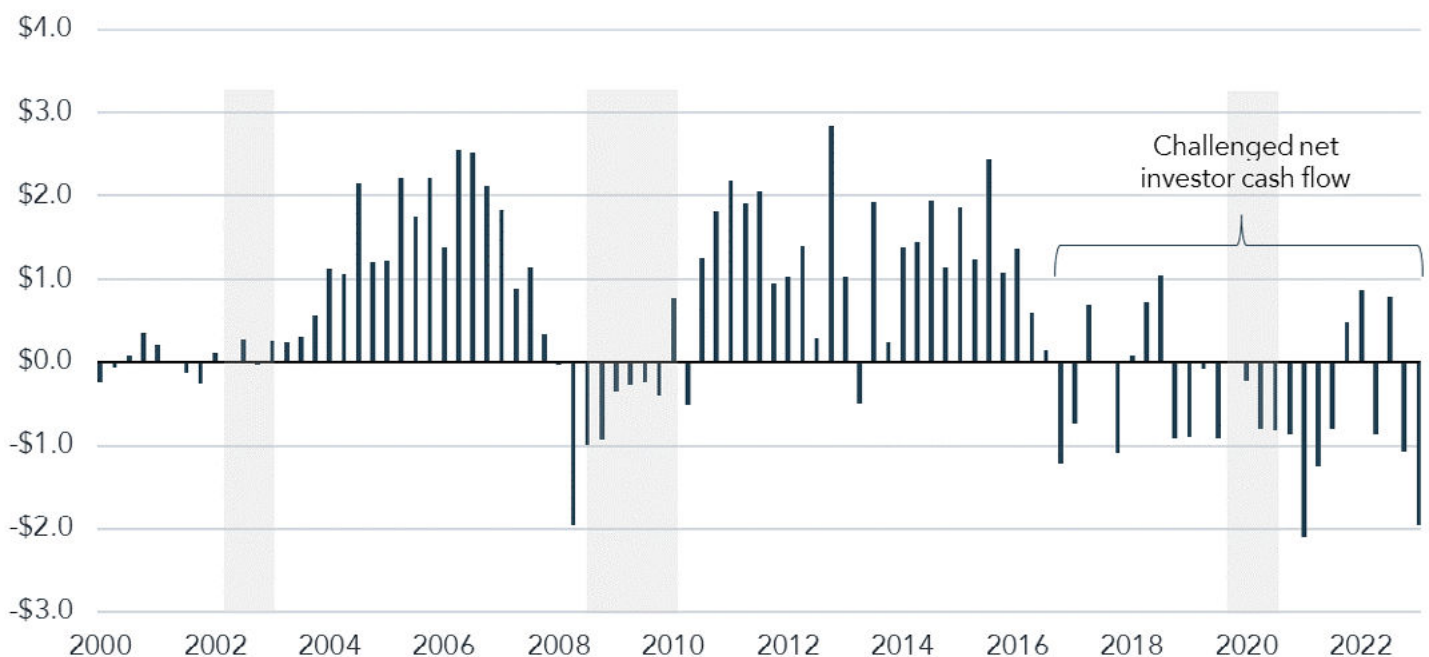


Investors can benefit from increased diversification to alternative sectors

Core traditional real estate has struggled to maintain capital inflows in recent years, as once critical investible sectors face secular demand challenges and investors remain uncertain on the near-term macroeconomic outlook. The current market dynamic is reflected in the performance of the NCREIF-Open-End Diversified Core Equity Fund Index ("NFI-ODCE", "ODCE"), a private index of open-ended core real estate funds predominately invested in traditional sectors, which has acutely felt these pains in recent years. The index has seen a rise in redemption requests and slowing contributions for its constituent funds.¹ Since 2016, the net investor cash flow has averaged -\$1.4 billion annually compared to +\$3.3 billion historically.² However, investors are not signaling a lack of faith in commercial real estate, but rather a need for near-term liquidity and hesitancy for some sectors within commercial real estate that are vulnerable to macro trends, a slowing economy and secular changes.

When viewing sectors, the traditional property types – the office, industrial, retail and apartment sectors – have faced new challenges. In particular, the office sector has struggled following the pandemic-induced rise of remote work, which has heavily slowed demand for space due to rising vacancy rates and an unclear outlook for future demand. Retail has faced headwinds alongside the rise of e-commerce and an oversupply of space devoted to physical retail. The apartment sector has cooled due to softening rent growth following the pandemic. Additionally, many investors are seeking to reduce exposure to the industrial sector which saw meteoric returns in recent years and is at risk of mean reversion if prices correct. Sector allocation is increasingly important for commercial real estate investors, which begs the question – **should core real estate investors contemplate more diversification into the alternative sectors?**

Figure 1: Net cash flows for the NFI-ODCE index have been challenged since 2016
NFI-ODCE Net investor cash flow, billions of dollars³

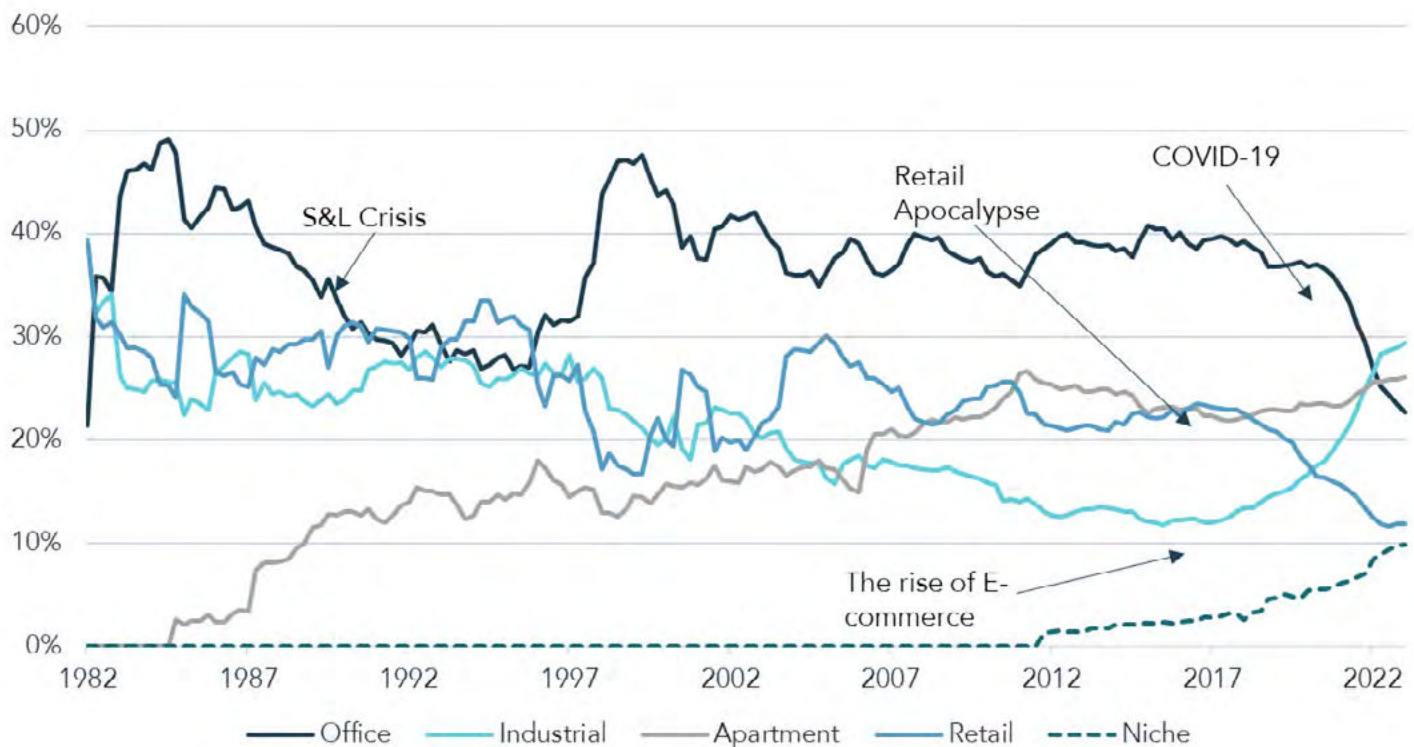


Source: NCREIF NFI-ODCE Index, 2023 Q1

Core real estate lacks adequate diversity

The NFI-ODCE index, with data comprised of 26 funds, has a rich history, with its inception reaching back to 1977. For inclusion in the index, funds are required to have at least 75% of market value invested in the traditional property types – office, industrial, retail or apartment. Additionally, funds must be invested in at least three of those four property types, with no more than 60% allocated to one property type and a minimum of 5% in each of those three property types. These diversification requirements for traditional sectors are emblematic of an age when these sectors were the premier destinations for real estate investment capital.

Figure 2: Core real estate allocations have begun to fundamentally shift
NFI-ODCE Sector allocations, % of total market value



Source: NCREIF NPI-Plus, 2023 Q1; Data calculated from properties held in NFI-ODCE Funds

Over the course of the index's history the office sector has almost always represented the largest single sector allocation. Retail only briefly overtook the sector in the early 1990's driven by America's infatuation with malls and due to the financial industry's distress amid the Savings and Loan Crisis in the 1980's and 1990's, which negatively impacted the office sector. The office sector's dominance has changed significantly in the past few years, however, as it fell from its pedestal and declined from 37% of the NFI-ODCE index in 2020 to 23% in 2023 Q1. This occurred alongside the rapid ascent of industrial, the avoidance of retail, rising interest in multifamily and the growing attention towards alternative sectors, the latter category now representing nearly 10% of total market value for properties held in ODCE funds.⁴ Yet, despite requirements intended to maintain diversification, nearly 90% of the NFI-ODCE index is invested into the four traditional property types. With many of these sectors struggling from secular demand shifts, or facing correlated performance during downturns, core real estate is constrained without the inclusion of more alternatives.

Why are ODCE funds increasing exposure to alternatives?

To gauge the recent increases in alternative exposure – and the potential for even greater emphasis in the future – it is important to understand why institutional investment in alternative sectors has historically been absent. In our experience, the dearth of historical investment was largely driven by: i) a lack of asset quality; ii) fragmented and sparse properties and operators; iii) limited scale for investment; and iv) inadequate data to support investment decisions. Over time, these issues have been overcome, which has led to the sizeable, and growing, investment in these sectors. Firstly, many new operators have emerged with advances in processes and technology to scale-up alternative opportunities and maximize margin growth. This, alongside capital improvements driven largely by public REITs and first movers, has also led to an increase in asset quality. Additionally, new data providers and expansion of industry-accepted indices, like NCREIF, have allowed investors to formulate and assess investment strategies. The result has been a considerable increase in liquidity among alternative sectors, with liquidity growing from an annual average of \$12 billion from 2001 to 2009, to \$46 billion between 2010 and 2023.⁵ Investment in these sectors has now garnered the attention of institutional investors, largely due to demographic-driven demand and strong, uncorrelated performance. With many traditional sectors facing headwinds, investors are now capable of and willing to commit capital towards these alternative sectors.

Alternative sectors are additive to core real estate portfolios

NCREIF began reporting on newly added alternative sub-sectors to their index in 2022 Q3, which provided a wealth of new data on the performance of alternative sectors. The inclusion of these sectors into the NPI-Plus index has yielded an important new analysis for properties held in ODCE funds and has demonstrated alternative's stronger returns and mitigated downside volatility. In fact, alternative sectors have seen a 14.4% average annualized total return since 2011 Q4.⁶ In comparison, traditional sector assets saw an 8.3% return over the same period. At current ODCE weightings, the inclusion of alternative sectors contributes minimally to aggregate total returns. **If the portfolio allocation to alternative sectors was increased to 40%, however, the NPI-ODCE would have seen an average additional 230 bps of average annual total return outperformance from 2011 Q4 to 2023 Q1.**

Figure 3: Alternative sectors offer strong risk-adjusted performance

NFI-ODCE Performance⁷

Q4 2011 - Q1 2023	NFI - ODCE	100% Traditional Sectors	100% Alternative Sectors	60% Traditional 40% Alternative	40% Traditional 60% Alternative
Average Annual Total Return	8.4%	8.3%	14.4%	10.7%	11.9%
Standard Deviation	0.017	0.017	0.020	0.018	0.0018
Downside Standard Deviation	0.023	0.024	0.008	0.017	0.014
Total Return vs. NFI-ODCE (Bps)	-	-8	593	230	350
Sharpe Ratio	29	2.7	5.4	4.0	4.5
Sortino Ratio	0.2	0.1	7.6	1.6	2.9

Source: NCREIF NPI-Plus, 2023 Q1; Data calculated from properties held in NFI-ODCE Funds.⁸

The historical analysis of performance data indicates there is significant alpha that can be generated from exposure to alternative sectors for core commercial real estate. The limiter for most core real estate funds will be the access to investment in these sectors, which can be seen in the relatively low allocation towards these sectors. Yet, there has been increasing interest in alternative sectors from investment managers due to strong returns, limited downside volatility and resilience during economic cycles. True diversification for core real estate funds will require additional investment into alternative sectors and organizations to rethink their diversification targets. Looking ahead, the expansion of commercial real estate into alternative sectors may be a requirement for managers looking to maximize their risk-adjusted return, as the inclusion of these sectors has historically been highly accretive to portfolio outperformance.

The emergence of alternative real estate as a core asset class can also be seen in Harrison Street's history as a leading investor in demographic-driven and needs-based assets, such as student and senior housing, medical offices and self-storage, among other categories. We believe our underlying alternative investment thesis has been validated across a 17-year track record – including two black swan events (Global Financial Crisis and global pandemic) – and reflects a vast array of proprietary data gleaned from \$65 billion of investing across alternative real assets. What we have seen is that a sharply focused alternative investment strategy, first mover advantage, right-scaled operations, and deep relationships with specialty operators, universities, health systems and lenders can be a competitive and unique formula in the alternative sector.

Disclaimers & Endnotes

Data as of July 13, 2023, unless otherwise noted.

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1 The NFI-ODCE is a capitalization-weighted, gross of fee, time-weighted return index comprised of contributing investment management funds

2 Through 2023 Q1, historical comparison between 2000 and 2015

3 Net investor cash flow is defined as contributions less distributions and redemptions

4 As of Q1 2023

5 MSCI Real Capital Analytics, 2023 Q2. Alternative sectors include Medical Office, Life Science, Data Centers, Student Housing, Senior Housing, and Self-Storage

6 2011 Q4 is the first reported datapoint for properties in alternative sectors within the ODCE index. Average annual total return refers to the average trailing twelve-month total return

7 Sharpe ratio is calculated using the 10-year treasury as the risk-free rate, with the latest value being 3.65% as of 2023 Q1. Sortino ratio and downside standard deviation are calculated using an 8% annual total return hurdle rate

8 Traditional sectors include properties held in ODCE funds in the Office, Apartment, Retail and Industrial property types. Alternative sectors include properties held in ODCE funds in the Self Storage, Life Science, Medical Office, Data Centers, Manufactured Housing, Single Family Rentals and Student Housing property types. NFI-ODCE figures include hotels, land, parking and other categories which are not captured in the traditional or alternative categories. Return statistics, comparisons, and ratios calculated by Harrison Street from NCREIF NPI-Plus, 2023 data



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