UBS Asset Management

New playbook: Institutional investors reevaluate their asset investments

How are U.S. allocations to real estate shifting relative to other assets?

Even as shifting capital markets prompt periodic reevaluations of portfolio allocations, real estate has provided notable benefits to institutional portfolios, offering stable returns, inflation-hedging capabilities and diversification advantages.

Institutional investors are targeting, on average, a 10.7 percent allocation to real estate, but their current allocation is 80 basis points lower, at 9.9 percent.[1] Interest rate-driven declines in real estate portfolio values, combined with the strong performance of public equities in 2023 and 2024, contributed to an underallocation to real estate. U.S. private commercial real estate's Open End Diversified Core Equity (ODCE) fund delivered a –12.0 percent total return in 2023 and –1.4 percent in 2024, after 13 consecutive years of positive returns. Public equities delivered 26.3 percent in 2023 and 25.0 percent in 2024, further widening the allocation gap, but recent public market volatility could offset some of the difference. Despite an underallocation to real estate, institutions have largely refrained from making additional investments during the past two years. Concerns about elevated interest rates, muted transaction volumes and write-downs were stalling new capital allocation.

Despite current capital market challenges, fourth quarter data signaled real estate values have mostly aligned with the current cycle and transaction volumes have started to pick up. After more than two years of adjusting to higher interest rates, capital returns in most sectors turned positive during the second half of 2024. Improving capital market conditions and stabilizing debt costs supported commercial real estate transaction activity during the fourth quarter of 2024, which according to MSCI-RCA, was 40 percent higher than fourth quarter 2023 levels. Total 2024 volumes also exceeded 2023 levels by 12 percent. Transaction volume, aside from politically induced macro-volatility, is poised to continue to grow in 2025, generating more conviction that markets have bottomed out.

As debt markets thaw and transaction volumes rebound, we can expect allocations to real estate to pick up again; however, escalating geopolitical tensions could potentially delay the anticipated recovery. Downturns are rare in private real estate, which implies that the recoveries that follow them bring rare opportunities to establish a good basis and add diversification. Real estate remains a vital component of a diversified portfolio. Although the focus is now more nuanced, with a growing emphasis on sectors with strong long-term tailwinds, the asset class maintains a solid footing in achieving strong long-term risk-adjusted returns, as seen in Figure 2.

Does private real estate still hold a place in long-term strategic planning?

Private real estate has long been a staple in institutional investors' portfolios, providing diversification, stable long-term returns and an inflation hedge. Despite the evolving investment landscape, private real estate continues to positively contribute to long-term strategic planning.

Diversification

Private real estate is often less correlated with the public markets. This means performance does not always move in the same direction as other asset classes, offering a buffer against risk factors that impact the public markets. By investing in asset classes that respond differently to market conditions, investors can reduce risk while achieving more consistent returns over time.

Figure 1: 30-year correlation across asset classes

	U.S. private real estate	U.S. equities	U.S. bonds	U.S. Treasury	U.S. REITs
U.S. private real estate	100%	4%	-16%	5%	12%
U.S. equities	4%	100%	-4%	6%	63%
U.S. bonds	-16%	-4%	100%	21%	21%
U.S. Treasury	5%	6%	21%	100%	-1%
REITs	12%	63%	21%	-1%	100%

Sources: NCREIF, Moody's, NAREIT, Bloomberg. Data through 4Q 2024. U.S. private real estate data is represented by Open End Diversified Core Equity (ODCE) Index; U.S. equity is represented by the S&P 500 Total Return Index; U.S. bonds are represented by the Bloomberg U.S. Aggregate Bond Total Return Index; U.S. Treasury is represented by the three-month Treasury rate; and U.S. REITs are represented by the All-Equity REITs Index from NAREIT. Past performance is not indicative of future results.

Stable long-term returns

Over the long term, private real estate has achieved competitive risk-adjusted returns. With a Sharpe ratio of 0.9, private real estate delivered the highest return for the level of risk taken across asset classes during the past 30 years.

Although real estate performance has been weak during the past two years, downturns have been rare historically. Since NCREIF began in 1978, total returns have been positive nearly 90 percent of the time. Historical data reveals that on a rolling 10-year basis, unlike U.S. equities, private real estate has consistently posted positive returns during the past 30 years, as shown in Figure 3. On a rolling 10-year basis, private real estate has also consistently performed better than U.S. bonds and Treasury bills during the past 23 years, except for a slight dip below U.S. bonds in 2009 and 2010. Current market dislocation offers a rare opportunity to enter the private real estate sector at an attractive basis.

Figure 2: 30-year risk-return summary across asset classes

	U.S. private real estate	U.S. equities	U.S. bonds	U.S. Treasury	U.S. REITs
Return	8.0%	10.9%	4.6%	2.3%	9.6%
Risk	6.2%	16.5%	4.4%	1.1%	19.7%
Sharpe ratio	0.90	0.52	0.50	N/A	0.40
Maximum drawdown	–45.1%	–56.8%	–15.4%	N/A	–70.7%

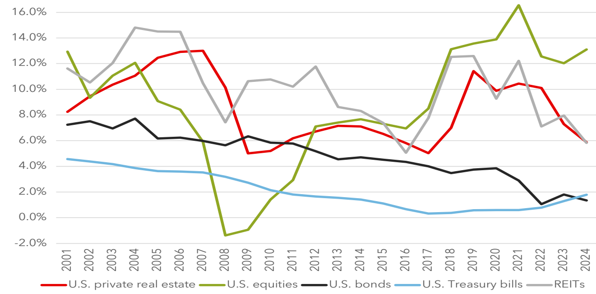
**The maximum drawdown occurred during the following periods: U.S. private real estate: 3Q 2008 – 4Q 2009; U.S. equities: 4Q 2007 – 1Q 2009; U.S. bonds: 1Q 2022 – 3Q 2022; and REITs: 4Q 2008 – 1Q 2009.*

Sources: NCREIF, Moody's, NAREIT, Bloomberg. Data through 4Q 2024. U.S. private real estate data is represented by Open End Diversified Core Equity (ODCE) Index; U.S. equity is represented by the S&P 500 Total Return Index; U.S. bonds are represented by the Bloomberg U.S. Aggregate Bond Total Return Index; U.S. Treasury is represented by the three-month Treasury rate; and U.S. REITs are represented by the All-Equity REITs Index from NAREIT. Past performance is not indicative of future results.

A hedge against inflation

Private real estate can provide stable and predictable cash flows. Rental income is the primary source of revenue for real estate

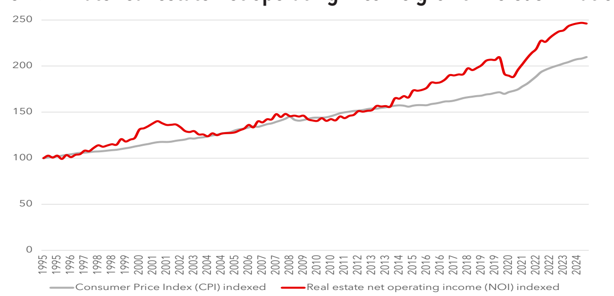
Figure 3: 10-year rolling average annual total returns by asset class



Sources: NCREIF, Moody's, NAREIT, Bloomberg. Data through 4Q 2024. U.S. private real estate data is represented by Open End Diversified Core Equity (ODCE) Index; U.S. equity is represented by the S&P 500 Total Return Index; U.S. bonds are represented by the Bloomberg U.S. Aggregate Bond Total Return Index; U.S. Treasury is represented by the three-month Treasury rate; and U.S. REITs are represented by the All-Equity REITs Index from NAREIT. Past performance is not indicative of future results.

investments, and as the price of goods and services goes up, rents tend to track closely. With inflation diminishing the value of money, increases in rent help preserve the value of income streams. Over the long-term, private real estate net operating income has kept pace with inflation.

Figure 4: Private real estate net operating income growth versus inflation



Sources: Bureau of Labor Statistics, NCREIF, Moody's Analytics. Data through Q4 2024. Indexed same-store net operating income is calculated using the NCREIF Property Index. Inflation is the Consumer Price Index (CPI). Past performance is not indicative of future results.

What role do emerging managers or specialist operators play in the new context?

Emerging managers, typically smaller or newer firms, are often characterized by their agility, willingness to explore new markets and ability to fill niche investment gaps. While larger firms tend to have a proven track record and experience in traditional sectors, emerging managers tend to specialize in specific markets and subsectors. With a growing emphasis on niche products that align with broader demographic and technological trends, emerging managers can fill the gap in capitalizing on specialized opportunities with greater expertise.

Established real estate investment firms have identified this gap and are increasingly partnering with or acquiring stakes in operators. These acquisitions are strategic moves to expand their portfolios into markets or property sectors with added expertise and scalability. By taking equity positions in operators, these firms can directly influence the management and performance of properties. Entity-level investing does, however, add complexity, dependency on operator performance and longer investment horizons. Investors need to carefully evaluate the management team, business strategy and exit options before committing capital to this structure.

Do REITs still have a role in a real estate portfolio?

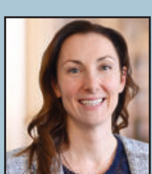
REITs enhance portfolio diversification. They offer investors a quick way to gain exposure to a real estate–adjacent asset class without direct property ownership. Liquidity is one of the primary benefits REITs offer as they are traded on major stock exchanges, allowing investors to buy and sell shares quickly in response to market conditions or changes in investment strategy. Another advantage of REITs is their ability to generate income. REITs must distribute at least 90 percent of their taxable income to shareholders in the form of dividends. This makes them an attractive option for income-focused investors seeking regular and predictable cash flows.

Given these advantages, why not solely invest in REITs to gain exposure to real estate instead of private real estate?

REITs are more correlated with stocks than with private real estate funds, as seen in Figure 1. In fact, a portion of a public REIT's price includes the value of the management company and its ability to add value. Private real estate funds, typically externally managed, rely solely on the performance of the real estate alone. Although REITs provide access to a broad spectrum of real estate sectors and geographic regions, they are also more volatile, as shown in Figure 2. As a result, investors can achieve stronger consistent returns at lower risk by diversifying across both private and public real estate. The advantages are further enhanced when asset allocation is customized for the specific plan participant, as seen with target-date funds commonly utilized in defined-contribution plans. Incorporating private real estate alongside public REITs has been shown to mitigate sequencing risk, where the individual's risk tolerance adjusts as they approach retirement.[2,3]

Notes: [1] 2025 Investment Intentions Survey, PREA. Survey results were carried out between October 2024 and November 2024.[2] Defined Contribution Real Estate Council (DCREC), 2024, "Better Together: Pairing REITs and CORE Private Real Estate to Strengthen Participant Outcomes"
[3] DCREC, 2014, "Allocating Real Estate Assets to Retirement Portfolios"

CONTRIBUTORS



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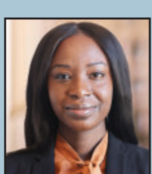

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UBS ASSET MANAGEMENT

UBS Asset Management's Global Real Assets business actively manages investments of around $115 billion* globally and regionally within Asia Pacific, Europe and the United States, making it one of the largest asset managers in real assets worldwide. Our capabilities reach across the risk/return spectrum, ranging from core to value-added and opportunistic strategies. We offer real estate, infrastructure equity and debt, and food and agriculture investments. Investors can access our diverse product range across open- and closed-end private funds, investment trusts, listed funds, REITs and bespoke separately managed accounts.

* Assets under management stated on gross asset values basis, reflecting values as of 30 September 2024, where available.

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