As Inflation Bites, Investors Can Hedge With Real Estate

By Patrick Carroll

CARROLL

With inflation at four-decade highs, construction costs soaring, and mortgage rates being driven higher by a U.S. Federal Reserve battling to avoid stagflation, you might think that real estate is a poor investment. But you'd be very wrong.

It's been a stressful year for most investors. The classic 60/40 stock/bond portfolio has struggled amid highly volatile financial markets. A recent report from Goldman Sachs noted that "today, a 60/40 portfolio [split between equities and bonds] yields less than 2% — a far cry from the 5%-plus offered in the '70s, '80s, and early '90s." One reason for those lackluster returns has been the fact that both stocks and bonds fell this year — an occurrence that is quite rare.

Historically, when stocks fall, bonds typically rise. And when stocks rise, bonds typically gain, too. On 10 occasions since the market crash of 1929, bonds fell as stocks rose. However, 2022 is just the fourth time since 1929 that stocks and bonds have fallen in tandem. The other three occasions were also truly awful investing years: 1931 (Britain abandoned the gold standard), 1941 (the U.S. entered World War II), and 1969, when, like today, there was runaway inflation.

It's a set of circumstances that has asset managers urging investors to try something different: investing in alternatives, an asset class that few individual investors included in their portfolios until recently. Insiders call this shift the "democratization of alternatives."

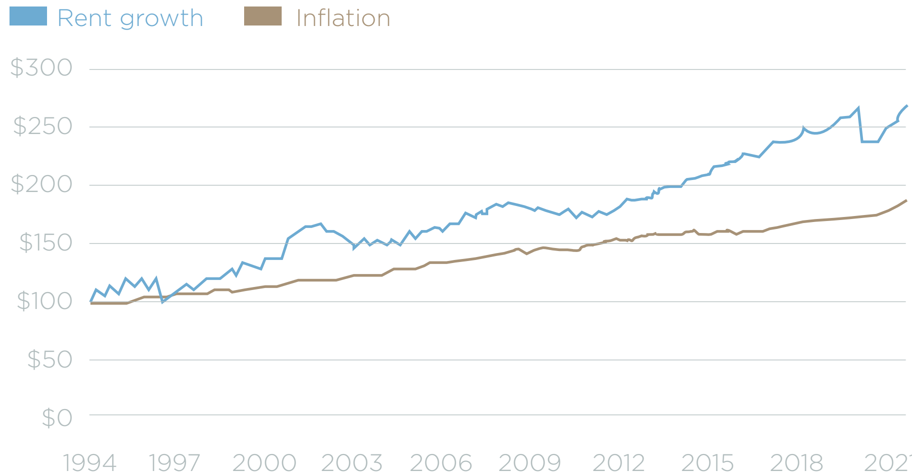
"Alternatives" is a blanket term for a variety of disparate investment choices, from private equity to private placements (the sale of securities, usually to a limited group of high-net-worth investors), as well as commercial real estate. Broadly speaking, it's everything that is not public equities or debt. Some alternatives are more natural fits for institutional investors, such as pension funds and insurance firms, because of their risk profile or lack of liquidity. For many individuals, real estate can be the most palatable choice, because it is accessible via publicly traded real estate investment trusts (REITs) with daily liquidity.

"Today, a 60/40 portfolio [split between equities and bonds] yields less than 2% — a far cry from the 5%-plus offered in the '70s, '80s, and early '90s."

But does real estate really offer diversification from stocks and bonds? Research from the Pension Real Estate Association (PREA) finds that real estate has a low correlation with stocks and bonds. (Low correlation indicates diversification.)

According to the PREA study, "the diversification benefits of real estate as an asset class are clear … with real estate having a correlation with equities close to zero and a slightly negative correlation with the total returns to bonds. In fact, the correlation of real estate with bonds is lower than that of equities with bonds, indicating that, despite often being described as having some bond-like characteristics, real estate is a better diversifier of bonds than is an equity allocation." The study also noted that rising interest rates and inflation do not impact real estate returns. "An allocation to real estate is a bet on much different things than are bets on stocks or bonds, the essence of diversification."

Rents are highly correlated with inflation



Sources: Nuveen Real Estate. Rent growth is represented by real estate net operating income: NCREIF. Inflation: Moody's Analytics, Jan. 1, 1994–Dec. 31, 2021. Past performance does not guarantee future results.

> "An allocation to real estate is a bet on much different things than are bets on stocks or bonds, the essence of diversification."

Concepts like these may be tough for non-academics to digest, but the message is simple: Investing in real estate can lower volatility in an investment portfolio, smoothing returns to make them less of a roller coaster.

One reason real estate is not impacted by rising inflation is that it has a high correlation with inflation. In other words, when prices rise in the overall economy, rents rise, too. Indeed, as shown in the graph above, since 1994 rents have far outpaced inflation.

"Real estate has generally served as a hedge against inflation over the long term," says Carly Tripp, chief investment officer of Nuveen Real Estate. Tripp adds that between 2000 and 2021, the average annual income from U.S. commercial real estate was 6%, as compared with 3.5% for U.S. investment-grade bonds, 2% for U.S. equities, and 1.5% for U.S. Treasury bills.

The reason income-producing property investments are such a natural hedge against inflation is that landlords can raise rents as properties become vacant in locations with low vacancy rates.

As a result, at a time of volatile financial markets, real estate can offer attractive risk-adjusted returns while also smoothing returns for the overall portfolio. At times such as these, that's something investors can cheer.

CARROLL

Patrick Carroll is the founder and chief executive officer of real estate investment firm CARROLL.