Principal Real Estate Investors

Private real estate's DC opportunity:

Private real estate is increasingly finding its place within professionally managed multi-asset investment strategies designed for defined contribution plan use.

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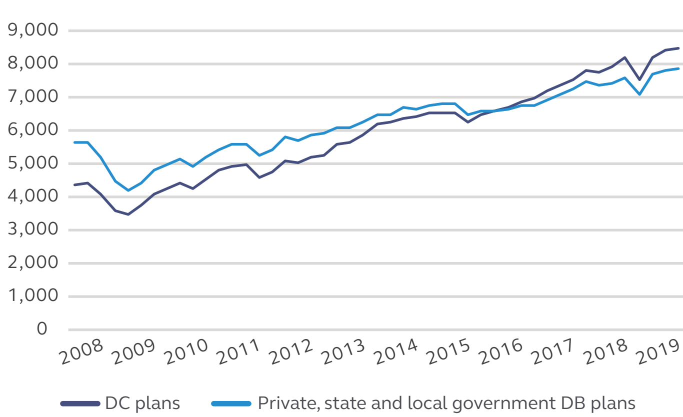
Private real estate has been available to defined contribution (DC) plans for over 30 years. The first daily valued, daily liquid offering has a track record of DC plan investment since 1982. Three additional offerings followed in 1995, 2006 and 2008, each with track records exceeding 10 years. There are now 16 daily valued private real estate-focused offerings available for investment by DC plans.[1]

Historically, REITs were the real estate vehicle of choice for DC plans, but private real estate is increasingly gaining its own allocation and, in some cases, replacing REIT allocations. Private real estate's place within investment strategies for DC plans is poised for growth with new regulation in place and its recognition among the proliferation of multi-asset investment strategies. However, questions on liquidity, fees and litigation remain key focal points for DC plan sponsors and consultants.

Overview of DC plans

In the last 30 years, DC plan assets surpassed private, state and local government defined benefit (DB) plan assets as the dominant retirement vehicle for American workers (see Exhibit 1). According to Willis Towers Watson, currently 81% of plan sponsors only offer a DC plan to new hires.[2] A primary catalyst of this growth was the passing of the Pension Protection Act (PPA) in 2006, which provided employers additional protections for taking a proactive role in helping employees save for retirement. Automatic enrollment in a 401(k) plan and an employer's ability to select a "qualified default investment alternative" (QDIA) in which to automatically enroll their employees, as allowed under the PPA, supported robust growth in DC retirement assets.

Exhibit 1: Total U.S. retirement assets



Source: Investment Company Institute, Q3 2019.

Target date funds (TDFs) are also a product of the last 30 years. First introduced in the early 1990s, TDFs have led the way in the development of multi-asset investment strategies. Such strategies are an easy and helpful way to gain access to professionally managed solutions for many DC plan participants who do not have the time and/or expertise to manage their own investment fund selections. The proliferation of TDFs has also been fueled by the PPA's approval to use TDFs as a QDIA (default investment) for a DC plan. Today, almost 71% of institutional DC plan sponsors automatically enroll employees into their DC plan to help employees start or maintain saving for retirement.[3] Additionally, 87% of plans use TDFs as the default investment, compared to 35% in 2006.[4] Automatic enrollment, plus a default into a TDF, has proven to be a major catalyst of growth in TDF use.

Another trend occurring within the retirement plan market is the rise in "outsourced CIO" or delegated services offered by the consultant community to DC plan sponsors. This has also been a source of growth in multi-asset investment strategies by helping to ease plan sponsor angst over fiduciary risk. Through such delegated services, consultants may take on a co-fiduciary role for investment selection, review and effective investment mix for offerings to DC plan participants. As consultants are armed with research teams covering all major asset classes, they are poised to help DC plan sponsors select, construct and oversee investment solutions that are best for a plan sponsor's employees.

[1] Defined Contribution Real Estate Council (DCREC), 2019.
[2] 2017 Defined Contribution Plan Sponsor Survey, Willis Towers Watson.
[3] 2020 Defined Contribution Trends Survey, Callan Institute.
[4] Ibid

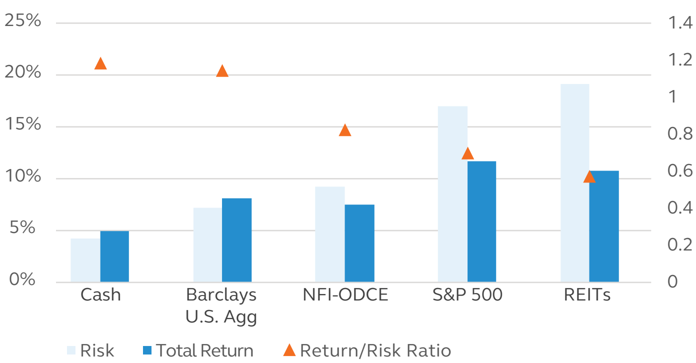
Exhibit 2: Private real estate is not highly correlated with other asset classes

Correlation matrix	S&P	NFI-ODCE	Barclays U.S.	REITs
S&P	1.00	0.18	0.22	0.54
NFI-ODCE	0.18	1.00	(0.18)	0.14
Barclays U.S. aggregate	0.22	(0.18)	1.00	0.26
REITs	0.54	0.14	0.26	1.00

Sources: NCREIF, NAREIT, Barclays, Bloomberg and S&P. Data as of Q4 2019.

Exhibit 3: Private real estate has historically provided attractive risk-adjusted returns

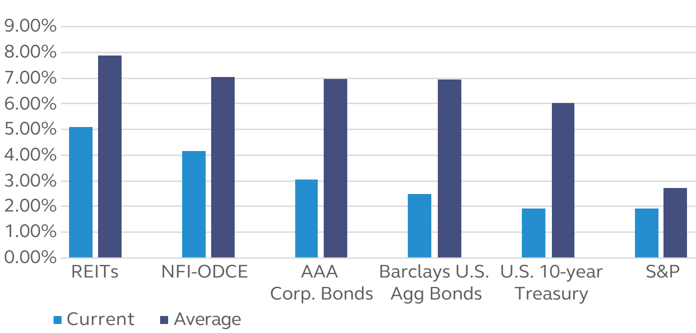
Returns and Volatility Across Asset Classes (1980-2019)



Sources: NCREIF, NAREIT, Barclays, Federal Reserve and S&P. Data of Q4 2019

Exhibit 4: Real estate provides yields comparable to/in excess of other yield-focused investments

Yields (1980 - 2019)



Sources: NCREIF, NAREIT, Barclays, Bloomberg and S&P. Data of Q4 2019

Real estate's place within multi-asset strategies

The proliferation in the use of multi-asset investment strategies has also seen an increasing recognition among investment strategy providers and plan sponsors that more than just stocks and bonds are needed as holdings within a well-diversified portfolio. Increasingly, private real estate is finding its place as an investment within such multi-asset investment strategies.

Private real estate has historically offered:

- increased diversification (see Exhibit 2);
- reduced portfolio volatility;
- income generation; and
- hedge against unexpected inflation (real asset).

As shown in Exhibit 3, private real estate has historically provided attractive risk-adjusted returns and, when added to a multi-asset portfolio, aids in dampening volatility of the overall portfolio. Some plan sponsors and professional asset allocators have identified this as a key characteristic and thus incorporate increasing allocations to private real estate midway through the glidepath to help decrease volatility as participants move closer to retirement. Exhibit 4 also supports use of private real estate as a means of generating income along the glide path.

Inclusion of private real estate to date has mostly occurred within custom TDFs constructed for the large DC plan sponsor community. Large plan sponsors ($1 billion-plus) are well versed in using private real estate within investment holdings for their DB plan and, in several cases, have requested the inclusion of private real estate within the custom investment mix they or their consultants built specifically to meet the needs of the employee demographics of their DC plan.

However, incorporation of private real estate has also occurred in off-the-shelf or pre-packaged TDF offerings. To date, five TDF series have included allocations to private real estate ranging from 5% to 15%, depending upon the position along the glide path. Growing support for private real estate inclusion is also occurring within white label funds centered on investment strategies such as a "real assets fund" or "inflation protection fund," with such funds largely offered and supported by the consultant community.

What about liquidity?

Because private real estate experiences periods of illiquidity during which investors are subject to investment or redemption queues, liquidity has been a focal point for DC plan sponsors with most concern focused on redemption queues. There are three mitigating factors (and likely more) that address this concern:

1. "Set it and forget it" behavior of DC plan participants.
2. Professional manager use of strategic asset allocation ranges.
3. Advanced notice of DC plan changes.

A vast amount of industry analysis exists that points to DC plan participants exhibiting "set it and forget it" behavior and low propensity for participants to make changes after initial investment. Vanguard, in their annual How America Saves publication that shares data from across their DC record-keeping business (5 million participants), found that only 8% of DC plan participants traded within their accounts during 2018.[5] This behavior also occurred during one of the most volatile periods in market history in 2008, when 84% of DC plan participants did not trade.[6]

At the portfolio level, professional managers employ the practice of setting a strategic allocation range generally once a year for each underlying investment. Frequent rebalancing (e.g. monthly or quarterly) occurs to keep allocations within a range as market values fluctuate across multiple asset strategies in which the strategy (e.g. TDF) is invested. A service provider that has the ability to turn cash flows "on" and "off" to underlying investments of the multi-asset strategy is an essential execution tool to keep allocations within their range and in employing gates if needed, should the private real estate investment experience a period during which liquidity is not available. Service providers (custodians and record keepers) well-versed in this practice have aided in the inclusion of private real estate in custom, as well as off-the-shelf, multi-asset strategies.

In addition, the idea that 100% of the DC plan's assets need to be liquid 100% of the time is not as prevalent as it once was among the DC plan community. With the ability to rely on record keeper data to help understand behaviors of their own plan participants, plan sponsors are able to consider investor behavior when building or utilizing an investment strategy to aid in determining an optimal fit to help plan participants best achieve retirement savings outcomes.

For real estate fund managers looking to participate in the DC market, it is important to understand that DC plan sponsor interaction and behavior is different from DB plans. The number of third parties involved is far greater when working with a DC plan than a DB plan. In addition to consultants, DC plans rely on multiple service providers such as record keepers, trustees and custodians and, at times a separate trading agent, in effectuating the operation of their DC plan. This not only makes the initial decision, onboarding experience and ongoing communication more complex when working with DC plans, but also the notice period from a DC plan sponsor of any future changes is also longer. Changes that a DC plan sponsor wants to make to underlying investment options, service providers and the like are generally well known in advance (e.g. six months), which is helpful for a private real estate manager's cash planning.

And fees?

It is also well-known within the institutional investor community that private real estate's higher price tag is commensurate with the high touch nature of the asset class. To date, cost has been an inhibitor of wider adoption as many DC plans have increased their focus on expenses and shifted toward passive strategies during the post-Global Financial Crisis bull market run. However, as more DC plan sponsors and their consultants grow wary of the market's ability to continue to produce double-digit returns without much volatility, there is growing appreciation for the need to protect against the downside and diversify investments, with private real estate able to help address both. Hybrid strategies, including both active and passive funds within the underlying investment holdings, have been a popular way of mixing higher and lower cost strategies to blend to an overall fee that is palatable for DC plan sponsors.

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The question of litigation

DC plan sponsors are subject to litigation risk in their pursuit of assisting plan participants in saving for retirement, because perfect harmony is difficult to achieve among all employees when it comes to investment offerings and costs. Unfortunately, there are law firms who prey on this, leading to heightened plan sponsor sensitivity to litigation at a level that has arguably stunted innovation as a result. However, plan sponsors' increased awareness in being held to the same standards for their DC and DB plans and encouraging plan committee crossover has helped identify differences in plan investments that may not have originally been intentional but are now more evident without DB and DC committee separation.

There is also growing awareness that simply picking the lowest cost fund offerings may not avoid litigation. DC plan sponsors need to consider several other metrics such as how return characteristics (e.g. net returns and risk-adjusted returns) can affect retirement savings outcomes when choosing the right investments to offer. Hiring an outside fiduciary can help mitigate against unintentional plan design oversight, but it too does not completely shield a plan sponsor from litigation risk. Plan sponsors are not at risk for simply choosing to include or exclude certain asset classes within the investment mix for DC plan investment offerings; they are at risk if plan governance is lacking. In fact, one of the most important ways to mitigate risk is by ensuring there are well-documented policies and procedures of why and how investments were selected.

[5] How America Saves, Vanguard, 2019.
[6] Research Note, Vanguard, March 2009.

The next 30 years

DC plans have become the dominant source of retirement savings and multi-asset investment strategies serving as the primary investment options in the past 30 years. The next 30 years will undoubtedly bring about as much, and likely more change, as technology serves an increasing role in the retirement plan market.

With Baby Boomers now at or near retirement, increased focus on the decumulation phase will be of greater focus. We are already seeing more interest in investment strategies offering guaranteed income. In addition, the signing of the SECURE Act in December 2019 may bring more participants into DC plans as small- to medium-sized businesses evaluate banding together to utilize multiple employer plans (MEPs) versus offering their own DC plan. While MEPs could create larger pools of capital for investment, greater personalization is expected to occur within TDF offerings.

With the continued use of multi-asset investment strategies, the potential for larger pools of capital to band together via open MEPs and a greater focus on guaranteed income products, private real estate continues to be well-positioned for inclusion in, and a compelling investment for DC plans.

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