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Real Estate

Private real estate in defined contribution plans: A practical guide

Defined contribution (DC) plans have been adding private equity real estate into their custom target date and white label funds. Recently, Principal Real Estate Investors hosted a panel of several experts to discuss this trend, and what is needed to help ensure that plan participants can continue to access the same types of institutional-level real estate opportunities. The group discussed the practical aspects of setting the appropriate allocation, expense budgeting, managing liquidity, and working with partners such as custodians and recordkeepers to access this asset class efficiently and effectively. Following is a summary of their discussion.

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DC plans are no longer supplemental

Diane Smola, Managing Director of DC Real Estate Solutions for Principal Real Estate Investors, spoke about the current landscape for DC plans, as well as how commercial real estate can potentially help improve investment outcomes. DC plans, which surpassed defined benefit (DB) plans in total assets about five years ago, are the only retirement plan for many Americans. Today, 69% of plan sponsors offer only a DC plan to employees, while 70% of sponsors auto enroll their employees. As a result, the responsibility for retirement outcomes has shifted from employer to employee.

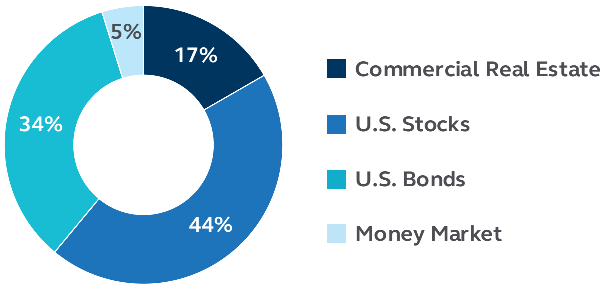
Historically, DC plans have included an array of equity and fixed income options. However, as the investment universe in the United States shifts and it becomes more important for participants to invest in a well-diversified portfolio, commercial real estate can be an attractive option. Endowments, foundations, and other institutional investors have long enjoyed the benefits of commercial real estate, which include the potential for diversification, lower volatility, an inflation hedge, and greater risk-adjusted returns.

DC plans traditionally utilized publicly traded real estate investment trust (REIT) strategies to gain real estate exposure, but the vast majority of real estate investments are private. The market has evolved to the point where there are now approximately 20 daily valued private real estate products available to DC plans. These private real estate funds strike a daily NAV, offer valuation transparency to investors, and are often available for automated trading via the National Securities Clearing Corporation (NSCC). These strategies are also very well-positioned for inclusion in multi-asset portfolios. The use of private equity real estate by delegated DC managers is on the rise, with 17% currently including private equity real estate in multi asset portfolios.

Exhibit 1: The commercial real estate universe

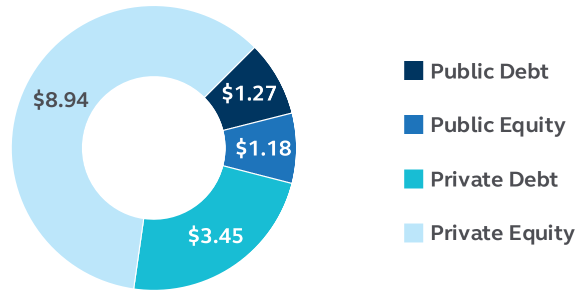
A fundamental and distinct asset class, totaling more than $14.8 trillion, with $8.9 trillion in private equity real estate[2]

U.S. market investment universe[1]



- Commercial real estate represents a meaningful piece of the investment universe in the U.S.

Commercial real estate universe in the U.S.[2]



- Commercial real estate remains primarily privately owned
- Fragmented & inefficient nature can create opportunities to add value at various points in the economic cycle

[1] As of 4Q 2020. Source: Property and Portfolio Research (PPR), Wilshire 5000, Barclays US Universal.
[2] As of 4Q 2020, Source: Federal Reserve, NAREIT, CoStar. Presented in $ trillions.

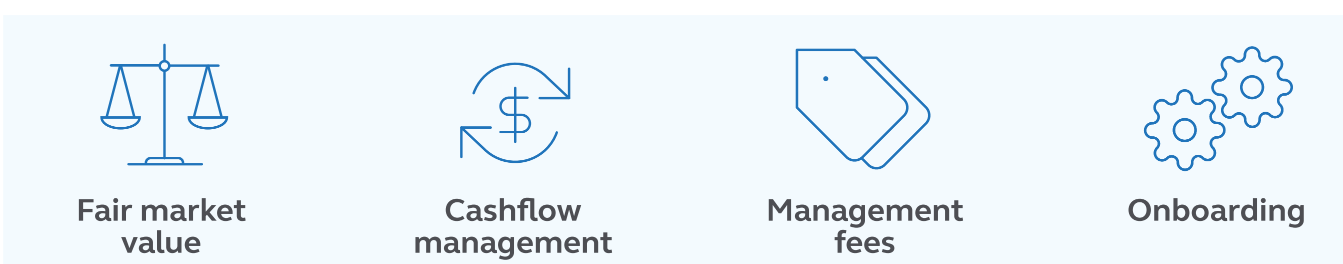
Key considerations when adding private real estate to a portfolio

One of the benefits of adding private real estate to a multi-asset portfolio is the potential to achieve the same expected return as a traditional 60/40 portfolio—but at a lower expected level of risk. Managers use a wide variety of approaches to private real estate allocations in multi-asset portfolios: some use a static 5% allocation while others employ a variable allocation ranging anywhere from 5% to 20%.

There are four primary considerations when adding private real estate to a portfolio:

- **Valuation:** At a minimum, the valuation methodology should include annual independent third-party property appraisals and quarterly limited scope appraisals. A more robust valuation methodology can also include a monthly statement of values by an independent consultant and the daily reflection of new market information like new leases.
- **Cashflow management:** Establish cashflow management practices. And have a contingency plan in place for accessing liquidity during market dislocations when liquidity may be reduced or limited.
- **Management fees:** Fee budgeting is also critical. Management fees for private investments are higher than those in the public market, so determine where and how to allocate the overall fee budget.
- **Onboarding:** Onboarding the investment can take significant time, so advanced planning is prudent. Onboarding depends on coordination of the key partners involved; understanding their roles and responsibilities will help lead to successful outcomes.

Exhibit 2: Operational considerations—Adding private equity real estate to DC plans



Mark Andersen, Senior Vice President and Manager at Callan, shared his firm's experiences helping institutions incorporate commercial real estate allocations into their portfolios. As DC plans replace DB plans as the retirement savings vehicle of choice and are now available to most American workers, Callan believes that the investment strategies from generations of DB plans can be applied to DC plans as well.

Institutional commercial real estate is a cornerstone of retirement plan investing but remains inaccessible to many savers due to its complexity and the private nature of the asset class. REITs have long been used as a substitute for private real estate in DC plans, and while the underlying asset is consistent, the securitization process introduces and imposes equity volatility and correlation that materially impacts the participant experience. Target date funds have a great deal of public equity, and in some cases if the REIT can be reduced and replaced with access to commercial real estate directly, it can improve the participant experience.

For DC plans, the participant experience is very important. The drawdowns that REITs can experience may make these products less attractive for DC plans and plan participants. The potential for equity market downside risk mitigation provided by private real estate can potentially reduce the risk that a participant will leave the plan. While REITs have experienced drawdowns in parallel with general equities, in some cases private real estate did not drawdown at all or the drawdown was quite muted.

Private real estate has also exhibited attractive diversification benefits relative to other staple asset classes in target date funds. This is not only true for equities, but bonds as well. Private real estate has shown more correlation to inflation than other asset classes, a valuable element in today's market environment.

Exhibit 3: Powerful diversifier

Correlations for 20 years ended December 31, 2020

	Inflation	Equities	PvtRE	REITs	Bonds
Inflation	**1.00**				
Equities	0.07	**1.00**			
PvtRE	0.23	0.10	**1.00**		
REITs	0.15	0.70	0.16	**1.00**	
Bonds	(0.21)	(0.32)	(0.19)	0.03	**1.00**

Inflation = CPI-U, Equities = Russell 3000 Index, PvtRE = NCREIF ODCE = wt Net Index, REITs = FTSE NAREIT Equity Index, Bonds = Bloomberg Aggregate Index

Sources: Callan, U.S. DOL, Russell, NCREIF, FTSE, Bloomberg

Additionally, cost is undoubtedly a factor for target date funds and DC plan design. There is no passive private real estate, so inclusion of this asset class will likely be one of the most expensive elements of a target date fund or multi-asset fund. Callan believes that prudent usage of active management and its fees can benefit retirement plan savers, and that private real estate is among the highest value exposures for a fee budget.

Valuing private real estate in DC plans

Jared Martin, Consultant and Partner at Innovest Portfolio Solutions, discussed how fiduciaries view the value private real estate provides relative to other asset classes. Part of fiduciary responsibility is not only the duty of loyalty to participants, but the duty of process. This includes making sure that DB and DC participants have access to similar opportunities. Investing in direct real estate is a perfect example of the transition over the years away from just equity or fixed income investments.

One of the core reasons direct real estate is an appealing investment for participants is its return characteristics. Private real estate returns, as part of a portfolio, are driven by income distributions and the price appreciation of underlying properties. Historically, real estate has also performed well in rising rate environments, posting positive total returns in all rising rate periods since 1977. The volatility and diversification benefits of investing directly in real estate are also important to highlight. Public REITs can experience more volatility due to more market risk and correlation to the broader equity markets, while the institutional focus of direct real estate investing can help reduce volatility.

Implementing private real estate strategies

Jonathan Kowolik, Senior Consultant and Principal at RVK, Inc., spoke about structural and operational issues to consider when investing in private real estate. Of the most critical: detailed consideration of operational topics and careful collaboration with stakeholders. Developments within private real estate funds, as well as other alternatives for DC plans, have facilitated the incorporation of private real estate in daily valued and daily liquid offerings. This has created more products available for trading via the NSCC daily valuation principles. While the multi-manager structure does help to isolate some of the concerns that may exist with incorporating private real estate in a diversified fund, it still requires effective daily pricing and consideration of liquidity and cashflow issues.

There are many stakeholders involved with implementing a private real estate allocation. These include:

- The investment manager investing the assets
- The plan recordkeeper that aggregates the daily participant trades and may provide investment option level trading
- The trustee/custodian that settles trades and reconciles with the recordkeeper
- The fund accounting services provider and trading agents
- Clients and advisors, who provide critical perspectives for initial implementation as well as review on an ongoing basis.

Stakeholders must consider a robust set of topics that will take time to fully comprehend. It's also prudent for investors to establish an ongoing review and documentation process with their partners to help ensure operational excellence and to continually consider and adopt best practices (which change regularly). Key topics to discuss include establishing target allocations, determining if a liquidity buffer (e.g., cash) is necessary for the investment, and establishing daily cashflow procedures. In addition, conversations must cover rebalancing procedures, along with any additional operational setup activities that are necessary (i.e., updating contracts, establishing new partner relationships, evaluating fee impact). From a valuation perspective, it's also important that fiduciaries understand and document the entire input/output process and maintain ongoing discussions with stakeholders about operational readiness and procedures.

Conclusion: New opportunities for DC plans

The shift from DB to DC retirement plans will continue, and it's important that plan participants are not excluded from opportunities to invest in the most promising areas of the market. As private equity real estate is increasingly becoming a part of DC plans, Principal Real Estate Investors believes plan participants should have access to this important asset class. By partnering with stakeholders and working to understand the challenges and opportunities within this asset class, plan sponsors building private real estate into custom target date funds or white label funds can feel confident they are giving their participants access to an increasingly important component to a diversified portfolio.

Risk considerations

Investing involves risk, including possible loss of principal. Potential investors should be aware of the risks inherent to owning and investing in real estate, including: value fluctuations, capital market pricing volatility, liquidity risks, leverage, credit risk, occupancy risk and legal risk. All these risks can lead to a decline in the value of the real estate, a decline in the income produced by the real estate and declines in the value or total loss in value of securities derived from investments in real estate. Past performance is not a guide to future returns.

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