The Case for Real Estate as an Asset Class

[Editor's Note: This is a guest post from Lawrence Fassler, the general Counsel of [Realty Mogul, Co.](), a real estate crowdfunding company that has previously purchased advertising on the site. In this post, he uses the term "commercial real estate" to refer to all types of investment real estate (single family homes, apartment buildings, strip malls etc,) not just commercial properties.]

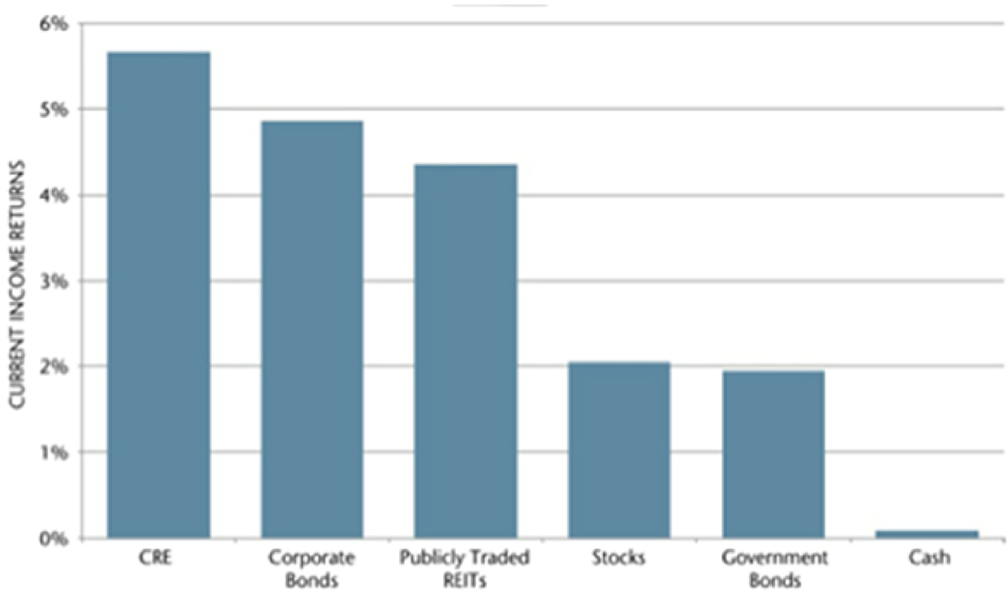
My company specializes in bringing to accredited investors opportunities in commercial real estate, a unique asset class that acts and behaves differently from many other investment classes like stocks or bonds. Major investment institutions generally allocate a significant portion of their investment capital to commercial real estate.

Commercial real estate can provide many benefits to investors. Here are some of the benefits that a commercial real estate allocation can bring to investors.

Cash Flow

Investments can produce both current income and appreciation (value changes). I focus on properties producing current income – cash flow – because we believe that stable income can provide some degree of protection during periods of stress in the financial markets. Real estate is different from stocks in this respect – the income component accounts for a much larger portion of total returns than it does for stocks.

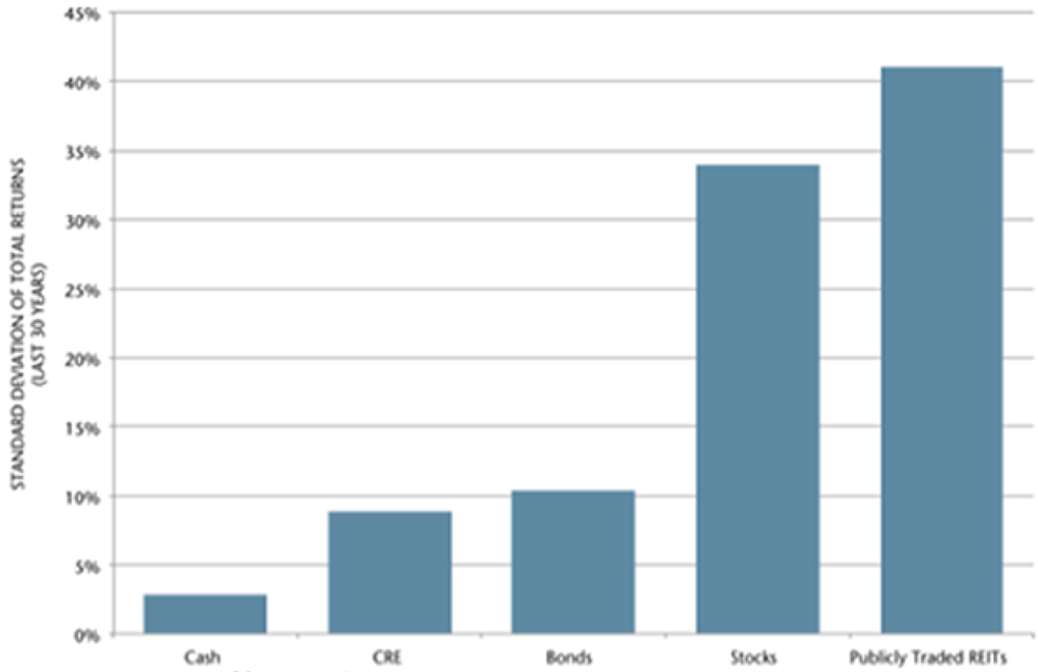
Recent low interest rates [lowering both bond and stock yields-ed] have made real estate income properties that much more attractive. Government bond yields are near all-time lows, and even corporate bonds don’t generally match the cash-on-cash returns available from the better real estate investments. Consider this chart demonstrating the annualized income from commercial real estate over one quarter (Q1 2013).



Past performance is no guarantee of future results.
Sources: National Council of Real Estate Property Index (NCREIF NPI) (CRE); Moody's Baa Corporate (Corporate Bonds); National Association of Real Estate Investment Trusts (NAREIT) All Equity REITs (Publicly Traded REITs); S&P 500 (Stocks); 10-Yr US Treasury (Government Bonds); 3-Month US Treasury (Cash)

Low Volatility of Returns

The income component of commercial real estate generally helps to temper its volatility as compared to asset classes like stocks, where price movements constitute a bigger portion of overall return rates. Despite the Great Recession, commercial real estate business cycles are often less pronounced – rental lease terms generally help to mitigate economic fluctuations and their impact on income. Over time, commercial real estate has generally exhibited relatively good stability – more akin to bonds than to stocks or even publicly traded REITs. The chart below, for instance, demonstrates the volatility of the returns (not price) of various asset classes from Q2 1983 to Q1 2013.



Past performance is no guarantee of future results.
Sources: NCREIF NPI (CRE); Barclay's US Aggregate (Bonds); NAREIT All Equity REITs (Publicly Traded REITs); S&P 500 (Stocks); 10-Yr US Treasury (Government Bonds); 3-Month US Treasury (Cash)
Note: Volatility is measured from quarterly annualized data.

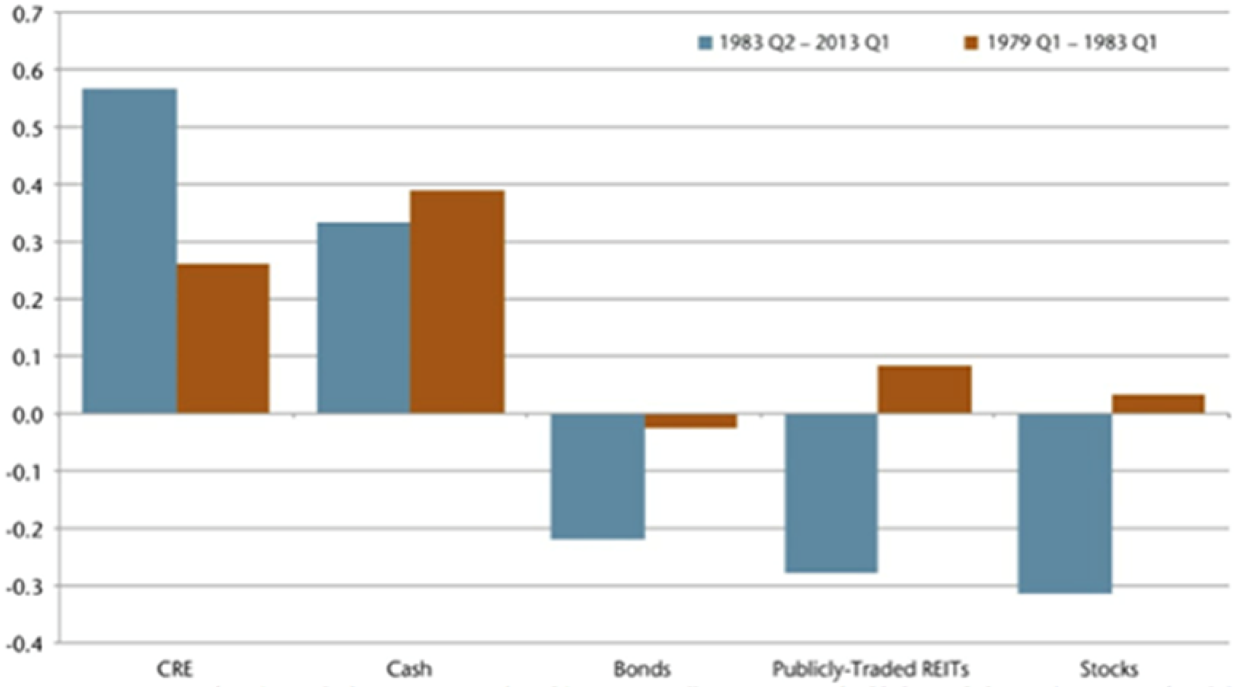
Real Estate is a Hard Asset

Real estate is a "hard" asset that has meaningful intrinsic value. Not only does the structure have value – so does the land itself. Well-chosen properties can provide some security that some value will be retained even if the property does not reach its full potential.

Hard assets are typically a strong inflation hedge, and *[some hard assets-ed]* can be used to produce other goods or services. In these respects, real estate is generally considered a relatively safe store of value. Banks are more willing to lend against real estate than they are against stock portfolios, for example.

Potential Hedge against Inflation

Commercial real estate has often been found to have a high degree of correlation to inflation as compared to other asset classes. As prices of goods and services increase in the broader economy, real estate can benefit, since rising wages and profits generally increase the amount that tenants are willing to pay for space. Those same factors also contribute to rising construction costs, so that replacement values tend to increase – driving existing commercial real estate prices higher as well. This chart demonstrates correlation coefficients between each of various asset classes and inflation, both over a long period of time (1983-2013) and over a short period of high inflation (1979-1983.) The higher the coefficient, the better the asset correlates with inflation.



Sources: NCREIF NPI (CRE); Barclay's US Aggregate (Bonds); NAREIT All Equity REITs (Publicly Traded REITs); S&P 500 (Stocks); 10-Yr US Treasury (Government Bonds); 3-Month US Treasury (Cash); BLS CPI (inflation); Cole Real Estate Investments

Diversification

Commercial real estate offers two ways to diversify your investment portfolio.

First, the return correlations of commercial real estate compared to other asset classes has historically been low. A drop in the stock market does not necessarily correlate to a fall in real estate. Commercial real estate is a longer-term investment; extended lease terms, sensitivity to development activity, and other factors give commercial real estate a meaningful ability to reduce portfolio volatility through diversification.

Second, diversification can also be found within commercial real estate. Each major commercial property type has its own set of economic drivers; offices are affected by job growth, multi-family apartments are driven by demographics, and business and leisure travel factors into success of hotels. Properties in different geographic locations can also help diversify a commercial real estate portfolio. Finally, investors can also participate not only in equity opportunities but also in lending investments, where investors act in many ways like a bank.

Tax Benefits

The tax benefits of direct participation interests in commercial real estate can be attractive. If properly structured, deductions related to depreciation, interest expense, and other items help to shelter or defer the taxes on cash distributions. Some or all of these tax benefits may be recaptured at the time of the property's sale [unless you wisely exchange it for another property-ed], but in the meantime investors may have tax-free use of the distributed cash.

Commercial real estate is the third largest asset class in the United States, representing nearly ten percent of the country's overall invested assets. Its ability to provide current cash flow, low volatility, a hedge against inflation, diversification, tax benefits, and its nature as a hard asset all argue for its inclusion in an investment portfolio.

What do you think? Do you invest in real estate outside of REITs? How and why? Comment below!