Private commercial real estate can diversify your portfolio

Most would agree that putting all your investments in one stock is not wise; diversification makes sense. And now that the market has reached not only new heights but also new levels of volatility, crystal balls abound whether, when and how big a "correction" might be. Diversifying out of publicly traded stocks into a different type of investment might make even more sense than ever. Investing in private real estate is unique in its ability to not only diversify a portfolio, but also enhance returns, avoid public market risks, simultaneously provide both cash dividends and capital appreciation and reduce volatility all while delivering tax advantages.

How does a private real estate investment do that?

Let's start with some definitions for context. **Modern portfolio theory**[1] is a way to evaluate risk and allocate your holdings, or portfolio to target a return consistent with your risk appetite. Simply put, it's about diversification. **Diversification**[2] means investing in asset classes that are not correlated. The gains from some asset classes will offset the losses of others resulting in lowering your portfolio risk below the sum of the risks of the assets. Diversifying asset classes moderates risk, but what is an asset class? And what does correlation mean?

Asset classes are a grouping of investments with similar characteristics that are subject to the same laws and regulations.[3] The 10 generally tracked asset classes are: 5 different Equities (Large Cap, Mid Cap, Small Cap, Emerging International & Developed International); Fixed Income; Diversified Portfolio; Cash & equivalents, Commodities and Real Estate. Commodities and Real Estate are two examples of what are referred to as Alternative Asset Classes.

Alternative assets, including commodities and real estate, are unique assets that behave very differently than stocks, bonds or cash. They tend to be less liquid than traditional investments, have a low correlation to equities and can serve an important diversification function in a portfolio, thus enhancing overall returns.

Alternative Asset Class Sector	Role Relative to Equities	Liquidity	Need for Specialized Resources	Expected Return vs. Equities	Expected Volatility vs. Equities	Expected Correlation to Equities	Investor Barrier to Entry
Private Equity	Return Enhancer	Low - None	Medium - High	Higher	Higher	Higher	High
Real Estate	Risk Diversifier / Return Enhancer	Depends	Medium	Slightly Lower	Lower	Very Low	Medium
Commodities	Risk Diversifier	Depends	Medium - High	Depends	Higher	Higher	Low
Hedge Funds	Risk Diversifier	Lower	Medium - High	Depends	Depends	Depends	High
Insurance Products	Risk Diversifier / Return Enhancer	High	Medium	Lower	Lower	Very Low	Low
Derivatives	Risk Diversifier	Depends	High	Higher	Higher	Equal	Medium

[1] Modern Portfolio Theory (MPT) (investopedia.com)
[2] What is Portfolio Diversification | Capital.com
[3] Asset Class Definition (investopedia.com)

Each sub class has distinct advantages and disadvantages to equities but when comparing real estate specifically it: diversifies risk, enhances returns, tends to be less volatile, is slightly lower in expected returns and has a very low in correlation.

Correlation is a measure of how closely two things move together in the same direction and is measured with values of +1 to -1. A "+1.0" is a perfect positive correlation; two assets move exactly the same. A "-1.0", is a perfect negative correlation, when one goes up, the other goes down. 0 means there is no relation, they act independently of each other.

Stocks from the same class are highly correlated, (> +0.8) and even stocks from different classes are correlated at just a slightly lower level. Bonds have historically been slightly negatively correlated and real estate is almost completely non-correlated at +0.07 to stocks over the last 30+ years. [4] That means real estate is fundamentally diversified from stocks.

How to compare asset classes. A standard way to compare and contrast asset classes and their performance over time is by an asset class returns quilt. Each asset class has a color assigned and every year are stack ranked with highest performing asset classes at the top and lowest at the bottom. This quilt shows a comparison over the last 10 years.

Performance drivers for any asset class in any given year are typically different than another asset class.[5] How different those drivers are between asset classes is core to determining correlation or

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[4] 45CA1E42-A07F-E5EA-C448-19C346183AAF (prea.org)

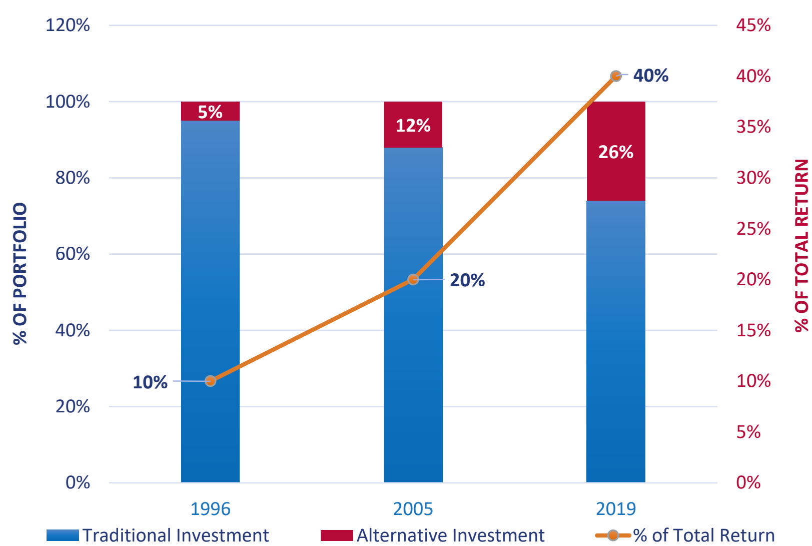
[5] Economic Outlook Recap and Updated Quilt 2020 — Boyd Wealth Management (boyd-wealth.com)

diversification. And while there are no guarantees for future performance, real estate has performed in the top tier of asset classes 7 out of the last 10 years. Also, on a risk adjusted basis, it is the #1 performing asset class.

However, the asset class returns quilt reflects only data on publicly traded instruments. For real estate, it is the Dow Jones US Select REIT Index that measures the performance of publicly traded real estate investment trusts ("REIT"s) and REIT-like securities. It is a proxy for direct real estate investment and tries to approximate only the value of real estate, not direct payment of distributions.

What happens when alternative asset classes are included in a portfolio? For portfolios following Modern Theory, alternative investments have become a significant percentage of holdings. The Chief Investment Officer of the Yale Endowment, David Swensen popularized the *"20% rule"* advocating allocating at least 20% of a portfolio towards private alternatives with little/no correlation to traditional public traded assets.

The 20% Rule appears to be delivering results. According to a study by Blackrock, significant portions of a portfolio allocated to alternatives contribute more to the overall performance than merited by their volume. For example, a portfolio in 2019 derived 40% of its return from alternatives that represented 26% of its holdings.[6]



Public Markets vs Private Real Estate Transactions. There are additional advantages to investing in *private* real estate vs assets traded on *public exchanges*. Private market real estate trades are just that. Private transactions; and provide distinct advantages to the right teams.

Public markets are affected by macro forces, such as a teaser of the Fed's next quantitative easing announcement or a flurry of memes on twitter, that cannot directly impact the private sale of a warehouse in the same way. Public markets set price. Information is readily available. The ease/speed of transactions have reached new heights and transaction costs have dropped dramatically.

6 [Alternatives in modern portfolios – Institutional | BlackRock]

The chart below outlines key distinctions between investing in public vs private markets. While at first glance private real estate transactions may appear to be a disadvantage, when approached properly and with the right team, these same factors can provide a distinct advantage to investors. Let's review a few of the distinctions.

Public markets	Private markets
Liquid Easy to buy and sell investments	**Illiquid** Difficult to buy and sell investments
No Arbitrage Pricing is set by the market, with limited opportunities for arbitrage	**Arbitrage** Unpredictable pricing creates opportunity for arbitrage
Transparent Information transparency	**Opaque** Information asymmetry and opacity
Frictionless Low or non-existent transaction costs	**Frictional** High transaction costs
Scaled Many prospective buyers and sellers	**Fragmented** Few prospective buyers and sellers

Illiquidity – Is this a bad thing? In order for publicy traded assets to remain liquid they must hold a percentage of liquidity I.E. (cash) for client redemptions. Thus, the entire portfolio is not invested and lowers potential return. If liquidity is match with a clients long-term hold strategy, we view this as advantagous.

Opaque – Maybe. If you choose the right investment partner, there should be complee transparncy within the documents, operating agreements, and legal entities established. Can you go point out the specific property owned inside of a publicly traded REIT? Our investors can.

Frictional – To assume there is no transaction cost in publicly traded real esate deals is simply false. Generally, due to the size and scope of publicly traded deals, transaction cost get burried in the details. We believe exposre to hard costs helps keep them low and reasonable vs. burried in a prospectus.

Fragmented – A good property will have a buyer whether it is privately held or owned within a public REIT. In fact, manytimes the private markets can take advantage of inefficient segements of the market that are too small for publicly traded REITS to operate.

In sum, in addition to the benefits to the overall portfolio as an alternative to equities, with private real estate transactions, the very things that could be seen as a disadvantage to public markets, gives those with the necessary knowledge, skills, and resources a competitive advantage to earn above-market returns.[7]

Yield and Appreciation, simultaneously. To oversimplify, when investors pick an asset class, they generally are limited in picking either current income or capital appreciation. Of course there are exceptions, including the catch all asset category of "Diversified Portfolio". But if an investor chooses income, they will allocate part of their portfolio to the fixed income, cash or perhaps commodities classes. If they choose capital appreciation, it will be primarily the stock asset classes.

[7] Improve Portfolio Diversification Using Real Estate | Fundrise

Real Estate can play in both arenas.

Investors typically evaluate private transactions based on two factors. First, the cash-on-cash returns or yield the project delivers. Simply put, if they invest $100, they expect a check annually of $8-$10. Or an 8-10% yield. Depending on the property, that yield could be higher or lower and if cost segregation is employed, every year when they receive their K-1, they might also get a nice tax deduction to offset some of that income.

On those same transactions, usually a sale is also anticipated. The property is sold at the current local market value, the mortgage is paid off and after sale expenses are paid, the remaining cash is distributed to the investors as a capital gain. That reflects capital appreciation on the asset, just as if a person bought a share of stock for $100 and sold it 5 years later for $150. While there is current discussion of eliminating this portion of the tax code, today there is then an opportunity for the investor to postpone recognition of that capital gain through a 1031 exchange, either directly or through a Delaware Statutory Trust intermediary.

The total return on a private commercial real estate investment is typically this combination of cash yield and capital appreciation on sale. And that blended return, along with diversification arguably puts real estate into a unique asset class all its own.

Private real estate is a unique diversifier of a portfolio because:

- It is effectively non-correlated to public traded stocks.
- It has historically performed in the top quartile of all asset classes and on a risk adjusted basis is the number #1 performing asset class in the last 10 years.
- As an alternative asset, it reduces risk in the portfolio and over the last 25 years has delivered portfolio returns well past its allocated amounts.
- It can uniquely provide both current income and capital appreciation.
- It typically provides tax benefits, both offsetting current distribution and potential for rolling forward capital gains through a 1031 exchange.
- Private deals are not exposed to the same market forces as publicly traded assets and create unique investor opportunities.

Prevail Innovative Real Estate is pioneering a different approach to provide access to curated private real estate transactions that provide diversification to an investor's portfolio. For more information, contact Brad Clark, Managing Director at bclark@prevailiws.com or call 913 689 2449.