THE ROLE OF REAL ESTATE IN INSTITUTIONAL PORTFOLIOS

Man | Global Private Markets

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February 2017

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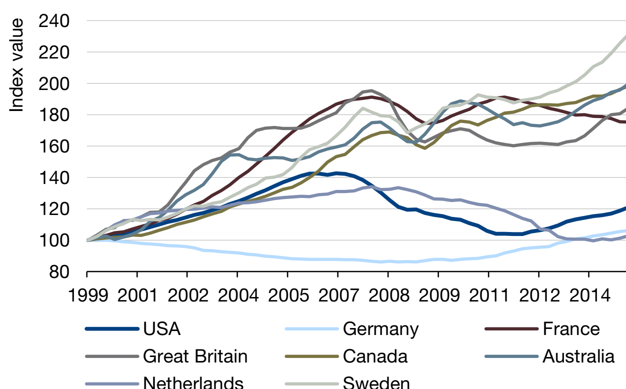
Institutional investors have a much tougher job today than they did 3 decades ago. In 1981 the yield on a US 30 year bond surpassed 15% annualised. Today this figure is little over 3%[1]. We believe that replication of the recent past's performance is very unlikely, given that the amount of yield compression that would be required would take the increasingly hawkish Fed well through the zero bound. The investment environment seems to be on the cusp of considerable change, and we have been seeing an increasing number of large institutional managers showing a desire to include more unconventional and often illiquid assets within their portfolios. Real estate, both equity and debt, has been a beneficiary of this move. In our view, however, there are too many people being too blasé about the space. By our estimation, we are now around 8 years into a real estate bull market that has seen prices in some areas, such as US commercial, rise 39% above their previous record peaks[2]. We believe that this environment warrants a far more cautious and selective approach to real estate markets. In this paper we will briefly outline some of the ways in which we are implementing this careful approach.

On the equity side, we think that it is important to be very selective, and to eschew overbid 'trophy' assets in favour of less glamourous parts of the market. US single family residential ('SFR') is a case in point. We see valuations as being attractive, both relative to the precedent of recent history and from the perspective of comparing between geographies, as illustrated in figure 1. We believe that one reason why pricing is dislocated is that there is a paucity of major investors. Currently, the biggest player at the table is Blackstone, which controls 50,000 units. Estimates for total stock stand at around 15.7 million, implying that the area's Goliath controls just 0.3% of the available market[3]. We think that alpha may exist in this fragmentation.

Figure 1. US SFR versus other real estate segments[4]



From a fundamental as well as a technical standpoint, we view the space as offering better potential than the more crowded segments. US SFR is affordable for Middle America. To give some perspective, at USD 55,000, average household income in Atlanta is almost exactly the same as that of London. In Atlanta the average property sells for 2x income. In London, the equivalent multiple is 14x[5]. Stating this alone is an over-simplification – the supply of land in London, for example, is far more constrained – but it does demonstrate that the white picket fences of the American dream are well within the average family's reach, as we see it.

We think that the recent health of the US economy has only enhanced this affordability. Unemployment has fallen to 4.6%, down from a peak of 10% hit in December 2010[6]. Consequently, the average household's debt-to-disposable-income ratio now stands at 113%, back to the lows of the early 2000's, and well below other advanced economies such as Denmark (308%), the Netherlands (283%) and Australia (201%)[7]. This could well allow for greater availability of mortgage financing – which, according to some estimates, is down 80% since the GFC[8] – and this headroom offers a potentially attractively asymmetric upside for short term demand.

On a longer time horizon, potential demand also has a large right tail, in our view. America's 15-34 age cohort is large relative to other developed economies. Census data estimates that this bracket accounts for 27% of the population, versus 26% in the UK, 24% in France, 23% in Germany and 21% in Italy[9]. Numerous studies have shown this age segment to be the most crucial for family formation and, for obvious reasons of space constraint, 9% of multi-family apartments are occupied by families with children, versus 80% of SFR units[10]. Assuming America follows a conventional demographic trajectory, this could keep SFR supported well into the long term.

On the debt side, our caution in relation to the stage of the real estate cycle informs our preference for senior loans as opposed to mezzanine positions, which we believe offer better relative value. We see a variety of sectors that afford such opportunities. In US SFR, a dearth of suitable lenders offers attractive pricing and safety margins for those able to fill the gap, in our view.

We also see opportunities in European housing, specifically in Dublin. Here, irresponsible lending by local banks in the 2000's led to disastrous results in the aftermath of the GFC. Many of these institutions are still in balance sheet repair mode, with little capacity for new lending. This has impacted housing acutely, with virtually no new construction for several years, creating a potential opportunity

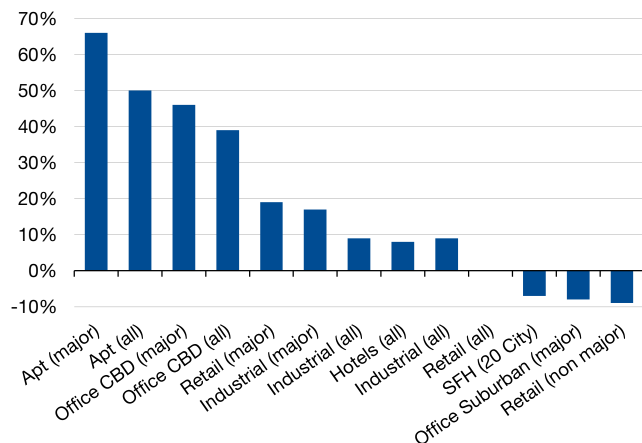
Past performance is not indicative of future results. Returns may increase or decrease as a result of currency fluctuations.

1. Source: Bloomberg. **2.** Source: Morgan Stanley. **3.** Source: Company reports. **4.** Source: The Economist. **5.** Source: Man GPM Aalto estimates (Atlanta), The Telegraph (London). **6.** Source: Bloomberg. **7.** Source: OECD. **8.** Source: Mortgage Bankers Association. **9.** Source: United Nations Department of Economic and Social Affairs, July 2015. **10.** Source: Man GPM Aalto estimates.

to originate lower-risk (around 30-40% LTV) and short-duration debt to fund both SFR and multi-family units.

Suburban office space in the US is another area which we think might be being overlooked and could be a good alternative to the more over-inflated parts of the real estate spectrum. As per figure 2, it is similar to US SFR in that it still has not overtaken its previous cyclical peak. This lack of recovery has been driven both by the runaway growth in more glamorous office developments in 'gateway' cities that has pushed suburban out of the limelight, but also by steepening regulatory requirements since the GFC, which has led lenders to jettison more niche business lines. As with SFR, in our view the ability to take up the slack left by the withdrawal of conventional lenders is being remunerated with a more attractive risk/reward profile than other sectors which have been bid up further through the cycle.

Figure 2. Current asset valuations relative to last peak[11]



At Aalto, we are not averse to taking on high risk exposure when we perceive that the stage of the cycle makes it attractive to do so. In 2012/13, for example, when valuations were at cyclical lows, our risk appetite was high. Today, however, the market environment is such that we believe in a cautious approach of targeting 1st lien loans at lower LTVs, as well as unlevered US residential real estate assets. For the latter, our approach focuses on broad geographies with low unemployment, growing populations and diverse job opportunities, across varied industries. We then dig down a level, filtering micro-locations by metrics such as average household income, low crime and, in particular, good schools. Equally, for our debt investments, we are seeking to preserve capital, keep durations tight, maintain full lender control and ensure that our lending focus stays on assets where we believe that our investors would be willing to own them on a direct basis, if required, following a cyclical downturn.

No-one knows the timing of the next downward correction in real estate, but it seems likely to us that we are now past the halfway point at the very least. Given this, we believe in building real estate allocations around long term fundamentals rather than short time euphoria, and in so doing we think that the space still represents a vital part of most institutional mandates.

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Mikko is Co-Head of Real Assets at Man GPM and a member of the Man Group Executive Committee. He is one of the founders of Aalto Invest and was previously their Chief Executive Officer and responsible for the real estate debt strategy with a particular focus on loan sourcing, underwriting and portfolio construction. Previously, Mikko co-headed Cheyne Capital's team responsible for real estate debt investments and illiquid alternative strategies. Prior to that, he was a vice president at Morgan Stanley's Investment Banking Division in London. He graduated from Helsinki School of Economics with a MSc in Finance.

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11. Source: Morgan Stanley.

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