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Real Estate: Built to Withstand Both Inflation and a Slowdown

Many investors are seeking assets that have the potential to maintain positive returns in an environment of high inflation, rising interest rates and slowing economic growth: the first half of 2022 has shown how damaging such an environment can be for both equities and bonds.

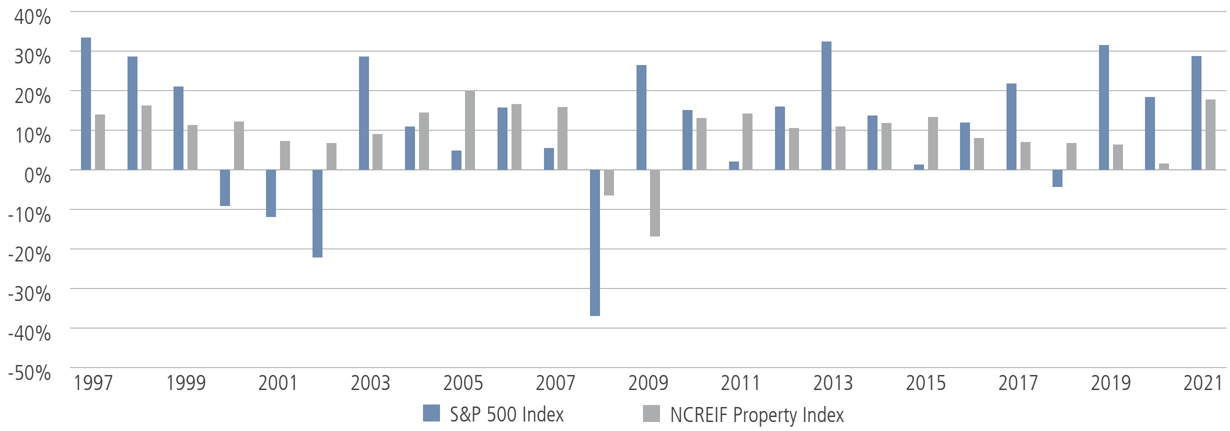
We believe real estate is an attractive asset class during these uncertain times, and that company-level real estate investing provides substantial advantages over other investable asset classes.

When we compare the calendar-year returns of the NCREIF Property Index and the S&P 500 Index over the past quarter century, one thing stands out: broadly speaking, real estate typically provided more consistent performance for investors, particularly during periods of economic slowdown.

Outside of the 2008 – 09 Great Financial Crisis, which had its origins in the sector, U.S. real estate never had a negative year. Perhaps most notably, real estate exhibited resilience during the last genuine cyclical downturn of 2000 – 02.

FIGURE 1. A RESILIENT AND CONSISTENT SECTOR

NCREIF Property Index and S&P 500 Index calendar-year total returns, 1997 – 2021



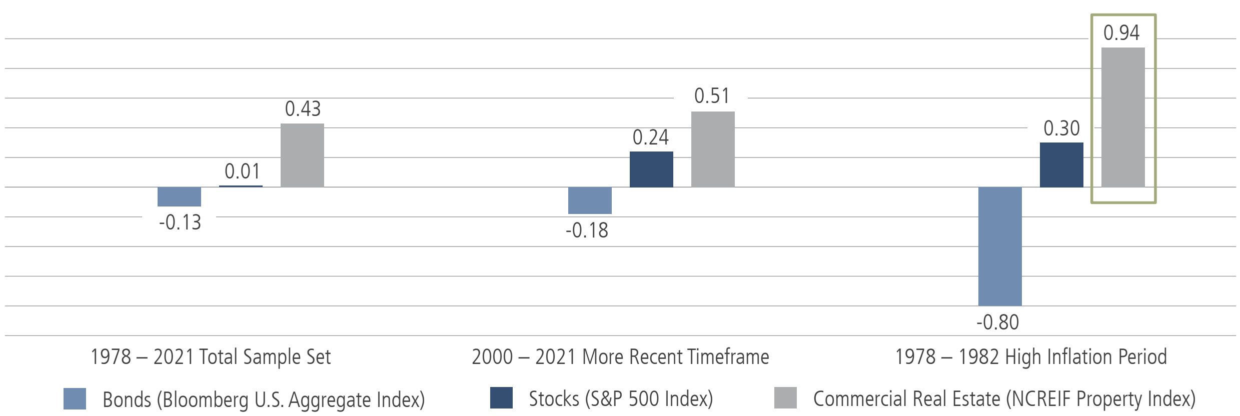
Source: NCREIF, Bloomberg. For illustrative purposes only. **Historical trends do not imply, forecast or guarantee future results.** Please see the Index Definitions at the end of this document.

We believe that there are several reasons for this relatively consistent return profile.

One reason is what we would regard as the real estate asset class's breadth and diversity: it encompasses everything from offices and warehouses to shopping malls, apartments and datacenters, each going through a distinct and often highly localized supply and demand cycle, and mixing short, intermediate and long-term leases. But perhaps most importantly, real estate generally provides an attractive combination of potential real-asset capital appreciation and current income, with overall returns typically exhibiting high correlation with changes in the inflation rate.

FIGURE 2. INFLATION-FIGHTING PROPERTIES

Correlation of monthly equity, bond and real estate returns with month-over-month changes in the U.S. Consumer Price Index, 1978 – 2021



Source: NCREIF, Bloomberg, Almanac. For illustrative purposes only. **Historical trends do not imply, forecast or guarantee future results.** Please see the Index Definitions at the end of this document.

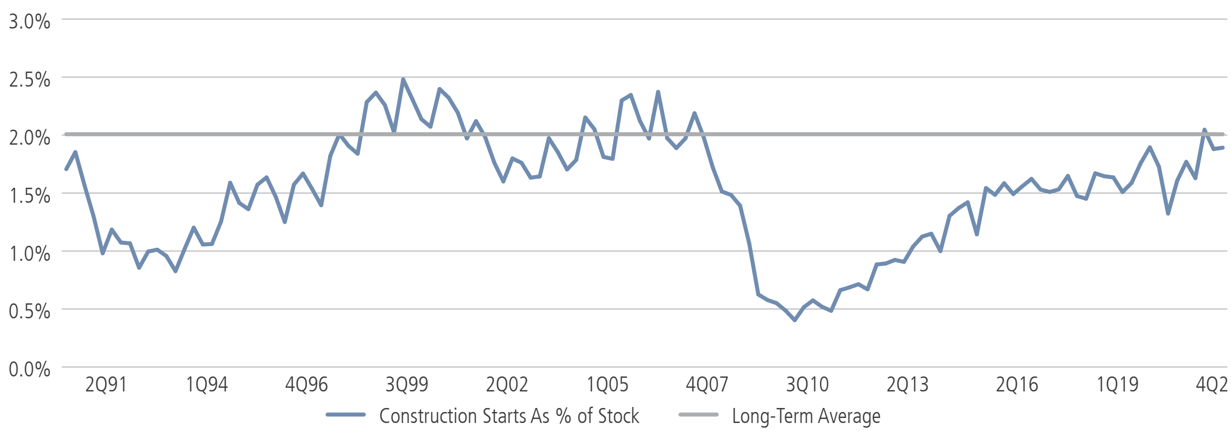
Rising Costs, Lower Supply, Higher Demand

To understand this dynamic, consider the consequences of rising commodity prices, wages and other construction costs. The cost of developing new buildings and replacing existing buildings increases, resulting in a reduction in supply growth relative to rising demand. That helps push up the value of existing structures and the land they occupy, and gives landlords greater pricing power, typically leading to rising rents. Furthermore, developers who decide to build into a rising cost environment generally require still-higher rents on their new properties to create an acceptable return to their investors, and that gives owners of existing properties even more room to raise their rents.

As figure 3 shows, despite more than a decade of low inflation and near-zero interest rates, the rate of supply of new buildings still hasn't regained the level it reached on the eve of the Great Financial Crisis. As the return of inflation threatens to disrupt even this modest rate of new supply, commercial property returns have begun to reflect the resulting rise in valuations and rents.

FIGURE 3. SUPPLY AND DEMAND

The rate of new supply remains below the long-term average, even as building costs begin to rise…



… and that is translating into higher property values and higher rents

Source: CBRE, Citi, as of Q3 2021 (top); NCREIF, as of December 31, 2021 (bottom). Please see the Index Definitions at the end of this document.

In short, real estate tends to perform moderately well when the economy is doing well, but it has defensive, cash-generative qualities during downturns and inflation-sensitivity when prices are overheating. For investors considering a scenario of slowing growth paired with persistently high inflation, and the significant market uncertainty that implies, we think that the characteristics mentioned above are attractive.

Structural Trends

Are there parts of U.S. real estate that are particularly well positioned for the current environment?

We think this is a question of idiosyncratic business fundamentals, but also of pricing power geared to structural trends—many of which have been given added momentum by the COVID-19 pandemic.

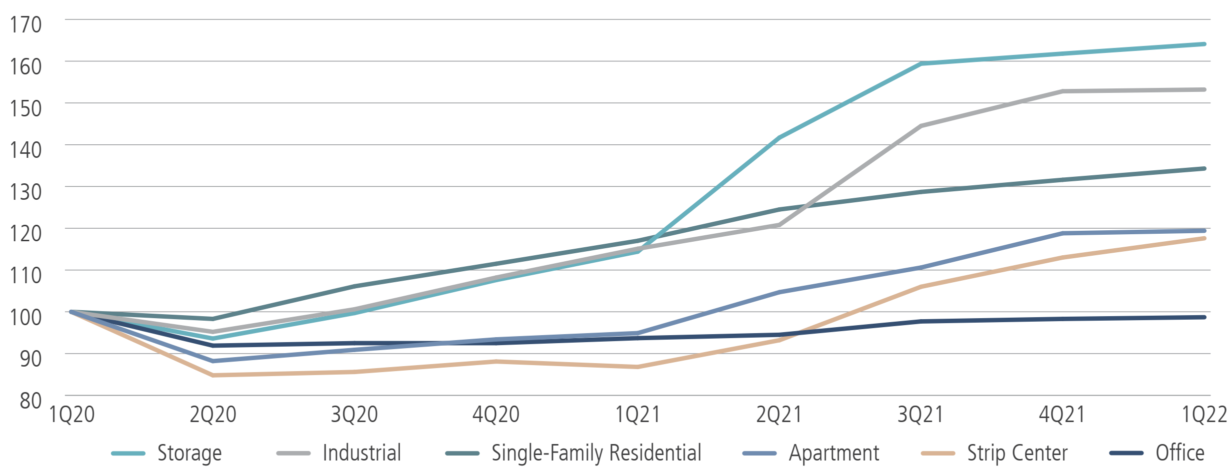
Some of these trends are reflected in the recent performance data shown in figure 4.

Rising wages and the excess savings built up during the pandemic are feeding into resilient consumer demand, but low returns to regional malls and very high returns to industrial warehouses are evidence of the shift of that consumption from bricks-and-mortar to online retail. Only the highest-quality and best-located physical retail spaces, such as convenience-oriented neighborhood centers and prime urban infill street retail, can sustain attractive returns, in our view.

Similarly, low returns to offices and high returns to apartments and single-family residential property reflect not only wage inflation, but also the ongoing move from major urban centers to suburbs, exurbs and smaller towns and cities, driven by hybrid working. Storage facilities are also benefitting from these trends: short-term demand has been coming from these home movers, but there is also longer-term demand from those who delayed leaving their parents' home or house share during the pandemic, or who continue to delay now that mortgage rates have spiked. These shifts in demand are driving up land and property values as well as rents.

FIGURE 4. STRUCTURAL CHANGES IN THE WAY WE LIVE AND SHOP

Commercial Property Price Index, rebased to 100 at 1Q 2020



Source: Green Street. Valuations are for properties owned by U.S. Real Estate Investment Trusts (REITs), and are appraisal- rather than transaction-based to mitigate data staleness. Data as of March 31, 2022. For illustrative purposes only. **Historical trends do not imply, forecast or guarantee future results.** Please see the Index Definitions at the end of this document.

Alignment and Governance

We also believe that investing in real estate at the company level rather than that of the underlying properties has benefits that come to the fore during times of economic volatility and uncertainty.[1]

Creating a new entity to acquire or develop a new project is complex and time-consuming regardless of the prevailing economic conditions. By contrast, a company-level balance sheet gives a real estate operator pre-committed capital on hand, typically making it easier to compete for new opportunities when they arise. That capital can also be invested in improving the value of the company itself by enhancing its operating capabilities.

Company-level investing tends to better align the interests of investors and real estate operators. An integrated company is overseen by a fiduciary board of directors and comes with audited financial reporting. By contrast, the typical joint-venture approach comes with no obligation to give capital providers governance oversight and carries limited reporting transparency, especially to any of the operator's outside business activities. As such, there can be strong incentives for the real estate operator to collect fees while either ignoring downside risk or neglecting to enhance upside potential—risks that most investors would want to keep an especially close eye on as they move into more difficult economic and market conditions.

Real estate has tended to get a prominent page in investors' inflation playbooks—and we think that is for good reason. We also think it has particular qualities that can make it resilient through inflationary economic slowdowns. Many areas of real estate exhibit pricing power today, including property types with well-established structural tailwinds. Over multiple cycles, Almanac has demonstrated its ability to invest in a diversified set of property types due to its bottom-up investment approach. And, finally, we believe that investing at the company level offers extra layers of alignment and governance that are likely to become especially valuable as the outlook becomes more challenging.

[1] See Matthew Kaplan, Robert Salisbury and Matthew Wolpert, "Building a Better Model: Real Estate Company Investing" (December 2020) at https://www.nb.com/en/us/insights/building-a-better-model-real-estate-company-investing

Index Definitions

The benchmark performance is presented for illustrative purposes only to show general trends in the market for the relevant periods shown. The investment objectives and strategies of each fund in the benchmark may be different than the investment objectives and strategies of private funds and may have different risk and reward profiles. A variety of factors may cause this comparison to be an inaccurate benchmark for any particular fund and the benchmarks do not necessarily represent the actual investment strategy of a fund. It should not be assumed that any correlations to the benchmark based on historical returns would persist in the future. Indexes are unmanaged and are not available for direct investment. Investing entails risks, including possible loss of principal. **Past performance is no guarantee of future results.**

The **S&P 500 Index** consists of 500 U.S. stocks chosen for market size, liquidity and industry group representation. It is a market value-weighted index (stock price times number of shares outstanding), with each stock's weight in the Index proportionate to its market value.

The **NCREIF Property Index** provides a historical measurement of unleveraged property-level returns. It is comprised exclusively of operating properties acquired, at least in part, on behalf of tax-exempt institutions and held in a fiduciary environment. It is a market value-weighted index including apartment, hotel, industrial, office and retail properties

The **Bloomberg U.S. Aggregate Bond Index** is a broad-based, market capitalization-weighted benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market

The **Green Street Commercial Property Price Index** is a time series of appraisal-based unleveraged U.S. commercial property values that captures the prices at which commercial real estate transactions are currently being negotiated and contracted. The index is based on Green Street's frequently updated estimates of price appreciation of the property portfolios owned by the REITs in its U.S. coverage universe. It is driven by the NAV models maintained by the research team, which, in turn, are driven primarily by changes in market cap rates and NOI growth prospects. Since REITs own high-quality properties, the index measures the value of institutional-quality commercial real estate. The index sector weights are: retail (20%), office (17.5%), apartment (15%), health care (15%), industrial (10%), lodging (7.5%), net lease (5%), self-storage (5%), manufactured home park (2.5%), and student housing (2.5%). Retail is mall (50%) and strip retail (50%).

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