

# Direct Investment in U.S. Commercial Real Estate

## IN BRIEF

- Direct investment in U.S. commercial real estate is a growing area of focus for institutional investors due to the potential to provide enhanced yields with low volatility, inflation protection and portfolio diversification.
- Over one, three, five and 10-year time periods, direct commercial real estate investment has produced significantly higher returns compared to treasuries and other fixed income investments, with returns on par with publicly traded REITs and equities, but with much lower volatility.
- Over the long term, commercial real estate has provided an effective inflation hedge, particularly during periods when the CPI has exceeded 1.5%. Much of this benefit is due to the protections inherent in lease terms.
- Direct investment in commercial real estate can also provide important portfolio diversification benefits through its low correlation to other asset classes, and its ability to provide stable yields.
- When institutional investors were asked about their expectations for future returns for commercial real estate, the consensus anticipates stable returns, on both an income and total return basis in the range of 5%-6% annually for the next five years.
- As a long-term asset class, a successful investment in commercial real estate utilizes a sharp focus on sustainability – relating specifically to green certified buildings, sustainable cities, and innovation hubs.
- With healthy economic growth, continued rent increases, low vacancies, and disciplined capital that has avoided the over-building and over-leveraging of 2008, U.S. commercial real estate offers attractive long-term returns, especially when adjusted for risk.

## THE BENEFITS OF DIRECT INVESTMENT IN U.S. COMMERCIAL REAL ESTATE

Investing directly in core real estate is a long-term strategy that can play a key role as part of an alternative investment mix. Investing directly in this asset class can:

- Increase portfolio diversification due to low correlation to other asset classes.
- Hedge against inflation through the protections inherent in lease structures.
- Enhance yields and capital appreciation.
- Provide stable yields by focusing on long-term sustainability principles.

Direct investment in U.S. commercial real estate is a growing area of focus for institutional investors as they evaluate their need for alternative assets to complement their core fixed income and equity portfolios, with the goal of providing additional yield opportunities without increased risk. Direct investment in U.S. commercial real estate provides investors with the opportunity to increase diversification, lower risk, hedge inflation, provide yields in excess of traditional fixed income investments, and benefit from sustainable investment practices.

### COMMERCIAL REAL ESTATE: AN OVERVIEW

Commercial real estate is dominated by four major property types:

- **Office** – downtown and suburban office buildings.
- **Industrial** – warehousing, flex space, R&D, and manufacturing.
- **Retail** – neighborhood, community, power centers, malls, specialty centers and high street retail.
- **Apartment/Multi-family** – garden, low and high rise apartments.

Within these four property types, there are four main investment strategies that investors choose to pursue, each with different timelines and risk levels.

#### Core Portfolios

A core real estate strategy is focused primarily on well leased, Class A buildings in major markets and highly desirable locations. For this reason, a core strategy is the most conservative of the four styles, providing stable, predictable long-term cash flow (primarily through income, less so through capital gains) with relatively low risk. Core strategies also typically use low levels of leverage.

#### Core-plus Portfolios

Core-plus strategies often focus on the same assets as core, but use higher leverage typically in the range of 30%- 50% in an effort to boost returns beyond those achieved through a lower-leveraged core strategy. Core-plus investing can also target alternative property types and smaller markets. As a result, core-plus has a slightly elevated risk profile compared to core, but still derives a substantial share of total return from income or yield. Both core and core-plus strategies will often include a “build to core” element, which takes advantage of development or redevelopment opportunities to generate additional return.

#### Value-add Portfolios

A value-add strategy involves income-producing assets that can benefit from improvements, redevelopment, or the repositioning of a portion or all of the property. Designed to decrease vacancy rates, command higher rents, and attract higher quality tenants, this is a medium risk strategy for short to medium-term investments, with a mix of capital and income returns.

#### Opportunistic Portfolios

Opportunistic strategies are higher risk, but with the potential for higher returns, primarily from capital gains. These strategies focus on properties that are often fully vacant and require significant rehabilitation. Opportunistic investors tend to target shorter hold periods, with a focus on gains from the added value that the redevelopment and increased leasing activity creates.

## A DEEPER LOOK AT U.S. COMMERCIAL REAL ESTATE MARKET RETURNS

Over one, three, five and 10-year time periods, direct commercial real estate investment represented by the NFI-ODCE Index (as shown in Figure 1) produced significantly higher returns compared to treasuries and other fixed income investments, with returns on par with publicly traded REITs and equities, but with much lower volatility. Direct commercial real estate investment also has a low to negative correlation to most other asset classes found in a diversified portfolio, (as shown in Figure 4). While publicly traded REITs are a real estate focused asset class, they are strongly correlated to equities and experience far greater volatility than direct real estate as shown by the higher standard deviation in the table below.

The National Council of Real Estate Investment Fiduciaries (NCREIF) – a non-partisan source of real estate performance information – produces both the NFI-ODCE (NCREIF Fund Index - Open End Diversified Core Equity) and the NCREIF Property Index (NPI). Both benchmarks measure quarterly returns for private U.S. commercial real estate held for investment purposes only and like other stock and bond indices, are capitalization-weighted.

NFI-ODCE investment returns are based on the performance of 24 open-ended commingled funds pursuing core investment strategies, some of which have performance histories dating back to the 1970s.

### Public versus private direct real estate investing

While publicly-traded Real Estate Investment Trusts (REITs) and direct private investment in commercial real estate both offer access to the commercial real estate market, REIT returns are more closely correlated to public equity markets.

The equity value of a share in a publicly-traded REIT is equal to the equity market price for that share. This value is subject not only to the value of the underlying real estate assets, but to non-real estate related factors too, most notably the volatility of equities markets in general. Conversely, private direct commercial real estate values are appraisal based and don't typically fluctuate in direct correlation to public equity markets.

This index is reported gross of fees, and measurement is time-weighted. As of Q1 2017, the index contained 2,508 properties with a combined gross market value of approximately \$220.3 billion, consisting of \$169.4 billion in net assets.

Similarly, the NPI covers most property types, but more broadly represents the U.S. institutional real estate market, as the index dates back as far as 1978 and contains over 7,600 properties totalling \$534 billion in market capitalization, as of March 2017.

Figure 1  
Source: Barclays, Standard & Poor's, NCREIF, NAREIT, Bloomberg

### Direct Commercial Real Estate Investment: Average Annual Total Return

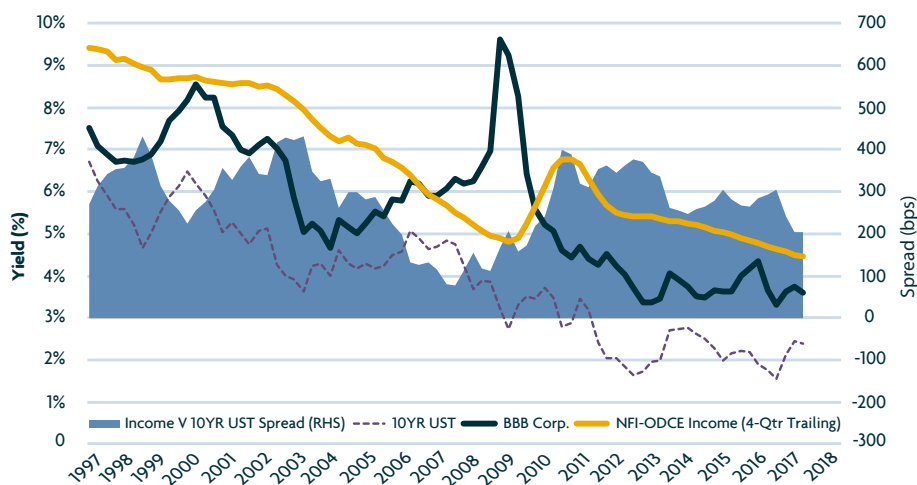
Period	T-Bills (90 day)	Consumer Price Index	Barclays U.S. Agg Govt Total Return	Barclays U.S. Agg Gov/Credit Total Return	FTSE NAREIT Equity REIT Total Return Index	NFI-ODCE Index	S&P 500 Index
1-YR	0.4%	2.4%	-1.3%	0.5%	5.2%	8.3%	17.2%
3-YR	0.2%	1.0%	2.0%	2.7%	10.6%	11.8%	10.4%
5-YR	0.1%	1.2%	1.6%	2.5%	10.3%	12.0%	13.3%
10-YR	0.7%	1.7%	3.8%	4.3%	5.0%	5.6%	7.5%
10-YR STDev	0.4%	1.5%	3.9%	4.0%	25.3%	8.7%	15.3%

With the different real estate property types, strategies, and performance over various time periods in mind, here's a closer look at the benefits of direct investing in commercial real estate that were outlined at the beginning of this paper.

## CONSISTENT YIELD SPREADS VS. TREASURIES AND BBB CORPORATE BONDS

Even with the recent Federal Reserve rate hikes, real estate's wide yield spreads over risk free rates continues, with property prices generally absorbing these initial increases. Figure 2 shows how real estate income (NFI-ODCE income) is highly competitive with yields from BBB corporates – outperforming them during most time periods and with less volatility. The NFI-ODCE income line also illustrates real estate's consistent long-term yield spreads over 10 year U.S. Treasuries.

### Yield Spreads



◀ Figure 2  
Source: Bank of America Merrill Lynch, Federal Reserve, NCREIF, U.S. Treasury

## EFFECTIVE HEDGE AGAINST INFLATION

Over the long term, commercial real estate has provided an effective inflation hedge – with much of this benefit due to the protections inherent in lease terms. Lease structures are often designed to pass the burden of increased operating expenses onto tenants. For long-term leases, rental increases are often built into commercial real estate contracts, while short-term leases, for instance in the apartment/multifamily sector, allow landlords to adjust rents relatively quickly.

The correlation between quarterly inflation and real estate appreciation is particularly positive in periods where quarter-over-quarter CPI changes exceed 1.5%. This means in periods of elevated inflation, commercial real estate can offer an even stronger hedge, when it's needed most.

### Inflation and Real Estate Appreciation

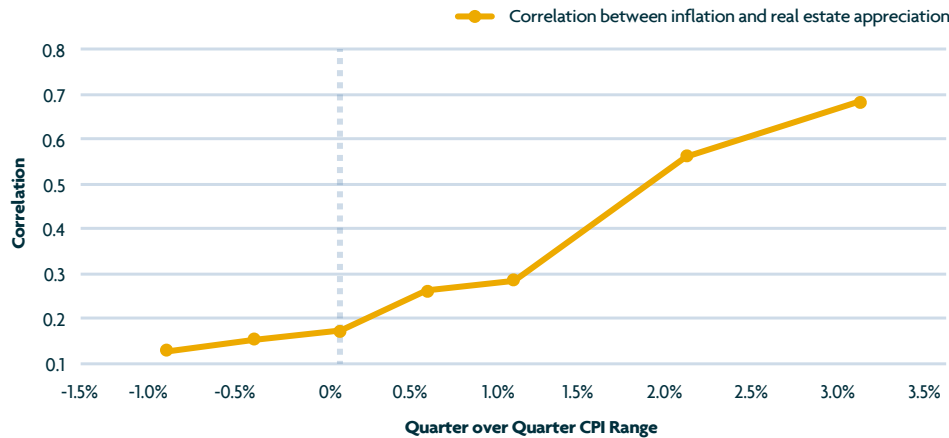


Figure 3  
Source: Bureau of Labor Statistics, NCREIF Q1 1978-Q1 2017

### CONTRIBUTING TO PORTFOLIO DIVERSIFICATION

In addition to providing enhanced yields and capital appreciation potential, direct investment in commercial real estate can also provide important portfolio diversification benefits through its low or negative correlation to other asset classes, and its ability to provide stable yields at lower risk levels.

Direct commercial real estate investment has demonstrated a low to negative correlation to most other asset classes found in a diversified portfolio, most notably to asset backed securities. Figure 4 demonstrates that real estate is a diversifying agent that can potentially supplement the fixed income portion of a portfolio.

### Correlation with Real Estate

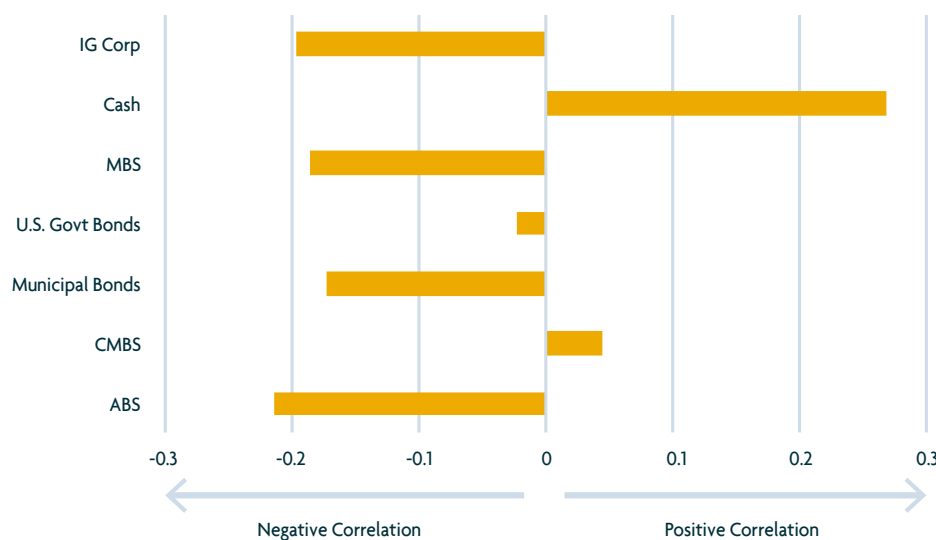
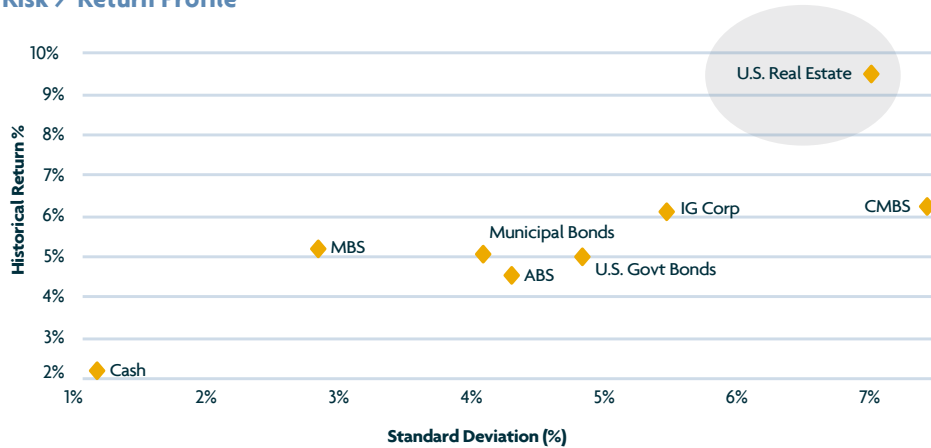


Figure 4  
Source: NCREIF, Morningstar Q1 1997-Q1 2017

Direct real estate exposure has also provided meaningful improvement to the risk/return profile of fixed income investment portfolios, with additional yield generated at average risk levels lower than those for REITs, for instance.

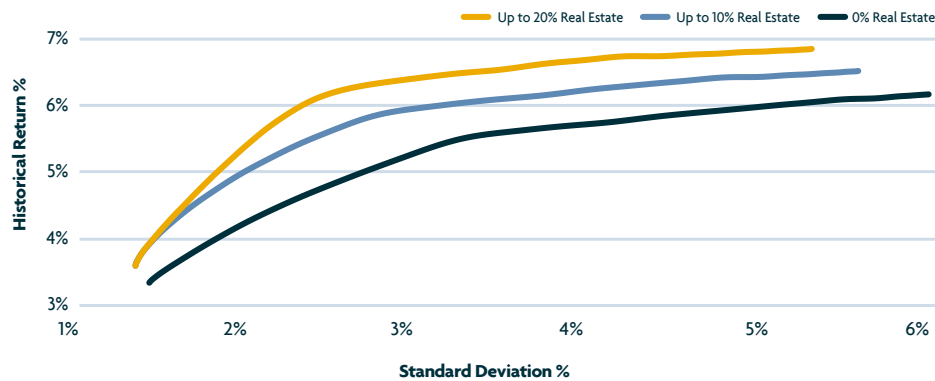
### Risk / Return Profile



◀ Figure 5  
Source: Morningstar, NCREIF  
Q1 1997 - Q1 2017

As a result, an increased allocation to commercial real estate within a multi-asset class portfolio has historically improved the risk-return profile. Therefore, as seen in Figure 6 below, investing directly in real estate not only contributes to portfolio diversification, but by adding real estate for its blend of lower volatility and stable returns, investors may reduce portfolio risk without compromising return.

### Real Estate Contribution to Portfolio Optimization



◀ Figure 6  
Source: Morningstar, NCREIF, Sun Life Investment Management

In order to test the contribution of real estate, the scenario test above set real estate's upper limit at 0%, 10% and 20% in portfolio mean-variance optimization. To avoid concentration, the maximum allocation to each asset class was bounded at a 60% cap. Returns and standard deviations were estimated through a historical total return series from Q1 1997 to Q1 2017.

## OUTLOOK FOR COMMERCIAL REAL ESTATE

According to Bentall Kennedy Group, the real estate subsidiary of Sun Life Investment Management, direct investment in core U.S. commercial real estate remains strong, with particular strength in mixed-use urban hubs driven by innovative employers in technology, healthcare and higher education. What's powering this trend is the millennial cohort who is far less willing to commute to suburban corporate campuses for work. Instead, they're seeking opportunities in urban communities that offer a range of live/work/play amenities – entertainment, recreation, and residential options at different price points, and that emphasize environmental sustainability. Good transit access is also critical, but with a focus on active transportation such as walking and cycling. Employers in the innovation sector have responded by moving to where the talent is. These industries represent the growth areas of the U.S. economy and, as a result, these core hubs should achieve steady long-term appreciation in commercial real estate values.

The outlook for each of the four property types remains promising, as described in the Bentall Kennedy Group 2017 Perspective report:

### Apartment/Multi-family

While apartment vacancies rose slightly over the past year to approximately 5%, they remain well below historical average levels. Demand is strong and landlords continue to generate healthy net operating income growth. High rent levels and low vacancy are impediments to demand growth in many markets, but rising employment and wages should continue to benefit the sector.

### Office

Office vacancy fell 10 basis points over the past year to 13.0% as of Q1 2017, and current availability is on a par with early 2008 levels. Rents are rising nationally, albeit only at an inflation-like rate. Office-using employment growth continues to widely outpace non-office-using job gains, and improving corporate earnings should reinvigorate leasing in 2017. Office construction is well below levels observed prior to the recession and is not overpowering demand.

### Retail

Retail availability has improved, returning to levels last seen in 2008, but well-above prerecession lows. The sector remains challenged by the dramatic growth in e-commerce sales activity and the rising demand for experiential retail offerings, while a growing concentration of sales in urban retail nodes are disrupting the sector. However, rising employment and wages should support healthy growth in consumer spending during 2017. New construction remains relatively muted and retailers are tempering expansions, focusing new store openings on infill locations, as they work to deploy effective multi- or “omni”-channel sales strategies.

### Industrial

Prior to the first quarter of 2017, industrial availability had fallen for 25 straight quarters. Most recently, availability increased slightly but remains near its lowest level since the early 2000s. Tepid growth in areas such as industrial production and inventories has given way to surging e-commerce demand. The need for modern, efficient distribution space with high ceilings, multiple dock doors, and ample trailer parking has spurred most of the recent industrial construction activity. Supply growth shows no signs of abating, with more than 200 million square feet of distribution space underway, but strong demand should continue to keep availability low.

Source: Bentall Kennedy 2017 Perspective Report

“ Employers in the innovation sector have responded by moving to where the talent is. These industries represent the growth areas of our economy and, as a result, these core hubs should achieve steady long-term appreciation in commercial real estate values. ”

Furthermore, if we look ahead, when institutional investors were asked about their expectations for future commercial real estate returns, the consensus anticipates stable returns, on both an income and total return basis of 5% to 6% annually for the next five years. Figure 7 shows survey responses from a recent Pension Real Estate Association (PREA) Consensus Survey of the NCREIF Property Index.

### Average of Respondents' Forecast of the NCREIF Property Index (NPI)

	Total Return (incl. income) 2017	Total Return (incl. income) 2018	Total Return (incl. income) 2019	Total Return (incl. income) 2017-2021 (per year)
National, All Property Types (NPI)	6.3%	5.4%	5.1%	5.6%

◀ Figure 7  
Source: PREA Consensus Forecast Survey of the NCREIF Property Index – Q2 2017

### Why sustainable investing matters

Commercial real estate is a long-term investment, and investors want to ensure it holds and grows its value over time. That's where sustainability – something durable, something that lasts for the long term – comes in. A sustainable investment strategy for commercial real estate involves several different elements:

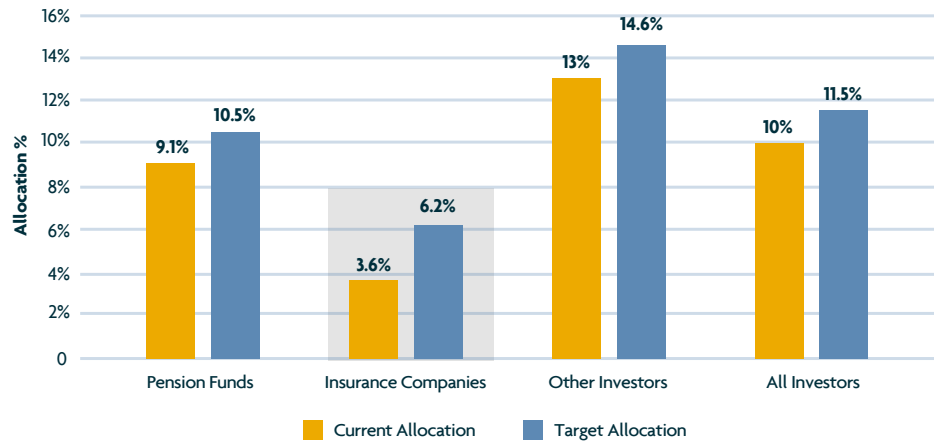
- A focus on green certified buildings:** Green buildings do more than just lower operating costs. Research conducted by Dr. Nils Kok of Maastricht University in The Netherlands and Avis Devine of the University of Guelph, Canada, found that properties with green building certification generated higher rents, had higher tenant satisfaction scores, and had higher renewal rates with fewer rent concessions.
- A focus on sustainable cities:** The growth areas of the future are ones that have the appropriate infrastructure, policies and planning in place – such as public transit, smart growth and environmental health – to attract people and businesses.
- A focus on innovation hubs:** There's a generational lifestyle shift occurring, with young people moving to live/work/play communities in core urban areas. And employers – typically in the high-growth innovative job sectors, such as technology, health care, digital entertainment, e-commerce and higher education – are moving to where this talent is, driving demand for residential, office and retail properties in these areas. Sustainable real estate investing goes beyond the walls of a building and focuses on live/work/play features of a community and tenant engagement.



## WHAT IS THE OPPORTUNITY FOR INSURANCE COMPANIES?

Institutional investors have long recognized the merits of a direct real estate allocation to their portfolios. However, insurers are displaying the largest “gap” between their actual and desired direct real estate allocation among institutional investors. Interestingly, this disparity exists even though some of the largest U.S. insurers operate direct real estate advisory businesses on behalf of third-party institutional clients.

### Current and Target Real Estate Allocations



◀ Figure 8  
Source: PREA Investment Intentions Survey 2017

## PORTFOLIO USES FOR REAL ESTATE

Here are a few ways that insurance companies (property-casualty (P&C) and life insurance) are taking advantage of investing in direct commercial real estate:

- They have invested in direct real estate to match the long liabilities within their general accounts.
- Life insurance companies and P&C insurers have utilized the asset class to help diversify their surplus portfolios and hedge against inflation.

With healthy economic growth, continued rent increases, low vacancies, and disciplined capital that has avoided the over-building and over-leveraging of 2008, U.S. commercial real estate offers attractive long-term returns, especially when adjusted for risk.

By partnering with the right real estate investment manager, with deep expertise and a long history with this asset class, institutional investors can deploy their excess liquidity to gain an important and often overlooked investment advantage.

## ABOUT SUN LIFE INVESTMENT MANAGEMENT

Sun Life Investment Management is a group of companies that provides investment solutions for institutional investors and insurance companies across North America. The Sun Life Investment Management group of companies are unique yet complementary businesses with one mission: to design and deliver investment solutions for liability-based institutional investors and insurance companies based on the long-standing history in liability-driven investing, real estate investment management and alternative, yield-driven asset classes. Each of the affiliates collaborate closely and work together to offer clients the best solutions to meet their needs leveraging capabilities across Sun Life Investment Management.

Prime Advisors, Inc.<sup>®</sup> provides performance-based asset management, accounting services, tax optimization, and asset liability modeling to clients across the insurance industry in the United States. Prime utilizes customized performance benchmarks so that portfolios are managed to achieve returns and manage risks to match each client's unique needs.

Bentall Kennedy ranks among the largest real estate investment managers globally and is a leader in sustainable investing. Bentall Kennedy serves the interests of more than 550 institutional clients with expertise in office, retail, industrial and multi-residential assets throughout Canada and the United States.

Ryan Labs Asset Management offers customized overlay strategies for defined benefit pension plans and other institutional clients in the United States. Through investment strategies – such as those using swaps and treasury futures – Ryan Labs can help investors hedge, offset or substitute specific portfolio exposures beyond those provided by the underlying portfolio assets.

Sun Life Institutional Investments (Canada) Inc. offers private asset class pooled funds – particularly in private fixed income and commercial mortgages – and liability driven investment strategies for defined benefit pension plans, insurance companies and other institutional investors in Canada.

**FOR MORE INFORMATION, PLEASE CONTACT YOUR PRIME ADVISORS, INC. REPRESENTATIVE.**

The Sun Life Investment Management group of institutional investment management companies comprises Sun Life Institutional Investments (Canada) Inc. and Bentall Kennedy (Canada) Limited Partnership in Canada, and Prime Advisors Inc., Ryan Labs Asset Management and Bentall Kennedy (U.S) Limited Partnership in the United States. This information is intended for institutional investors only and is not intended to provide specific financial, tax, investment, insurance, legal or accounting advice and should not be relied upon and does not constitute a specific offer to buy and/or sell securities, insurance or investment services. It is not for retail use or distribution to individual investors. Investors should consult with their professional advisors before acting upon any information contained in this document. All opinions and commentary are subject to change without notice and are provided in good faith without legal responsibility. Forward looking statements are speculative in nature and may be subject to risks, uncertainties and assumptions which could differ significantly from the statements.

© 2017, Sun Life Investment Management