Real estate's contribution to mixed-asset portfolios has been shaken by the global pandemic, but the foundation for strong performance in the future remains intact. As the crisis gradually recedes in 2021, we expect that real estate will remain attractive to investors seeking higher yields than investment-grade bonds and less volatility than growth stocks. The reasons for allocating part of an investment portfolio to real estate remain firmly in place.

Real estate portfolio construction is now a more complex task, with many options to consider. The range of investment styles continues to broaden and includes momentum/growth, a strong income or value orientation, and a dislocation/distress option. It is possible to tailor a strategy that combines domestic, international, mainstream, and niche positions in a way that would have been nearly impossible in the past. As secular growth trends slow down around the world, it also makes sense to examine the risk-return attributes of real estate debt, alongside equity. Debt can be structured as a low-risk, fixed-income substitute. It also works well as a moderate to higher risk strategy that relies on gaps in the capital markets as well as the broader real estate market to perform well, but with an added layer of downside protection.

Our updated estimate of the real estate investable universe in Chapter 3 highlights the rapid rise of alternative property types. A high-performing portfolio should have more of these non-traditional property types than in the past. The specialized nature of many of these niche property types means that investment managers will need to acquire new skills or partner with highly-skilled specialists, given the operation-intensive nature of data centers, life science buildings, student housing, self-storage, and other emerging sectors.

CHAPTER 3
PORTFOLIO STRATEGIES

The Case for Real Estate in 2021

After more than a decade of strong performance, real estate income was severely threatened in 2020. Fortunately, the initial financial effects of the pandemic turned out to be less harsh for properties' net operating income than many high-frequency[1] indicators seemed to signal. Rent collection levels appear to have avoided investors' worst fears, averaging above 90% for offices, rental residential, and logistics buildings and between 60% and 90% for retail properties among the higher grades of Class A and B properties. However, the lingering effects of a weakened global economy and new waves of coronavirus lockdowns, especially in the Americas and Europe during the winter of 2021, will hurt some tenants' ability to renew leases or to remain solvent.

The good news is that the entire asset class has not been permanently impaired in 2020. Moreover, institutional-quality assets have shown much higher resilience than older Class C properties. Nevertheless, the pandemic has created a serious setback in several sectors, especially those that serve the most vulnerable tenants, such as lower-income occupants and small businesses. It has also accelerated the secular decline of entire sectors in specific countries (e.g., regional malls in the U.S. and U.K.), nearly shut down other sectors temporarily (tourist-oriented retail and business hotels), while also boosting the fortunes of the logistics sector and specialized property types like data centers and life science buildings.

Taken together, stabilized and leased real estate are showing a high degree of resilience. Real estate's income spread to investment-grade bonds has widened as bond yields have fallen. In the current ultra-low interest rate environment, real estate typically offers fair value among other fixed-income alternatives. The resiliency of the asset class is based on the core principles underpinning any real estate allocation. The fundamental reason for including real estate in a mixed-asset portfolio is its long-term performance, which is not going to be undone by COVID-19. Other compelling reasons to incorporate estate include:

- **Strong risk-adjusted returns with diversification:** Real estate raises the risk-adjusted return of a multi-asset class portfolio in two ways. First, by maintaining competitive performance over many different cycles (see Real Estate's Relative Performance below). Second, by not moving in lock-step with other major asset classes, it acts as a shock absorber and diversifier when stocks, bonds, or other alternatives are volatile. Twenty years of correlations between major asset classes demonstrate the power of civersification through real estate.
- **Unique financial characteristics with inflation hedging:** Leased property has a different mix of contractual income and capital value than all other asset classes. Buildings generate rental income with varying

1 REIT prices plummeted 44% between February 21 and March 23. Footfall at retail properties fell by more than 50%, unless the shopping center was anchored by a grocery store or a drug store. Visits to office buildings in the largest cities that depend on mass transit fell by 90%.

Real Estate's Relative Performance

TRAILING PERIOD RETURNS BY ASSET CLASS AND COUNTRY: TO 2020:Q3*

Average Annual Total Return	Global Stocks[1]	Global RE Securities[2]	Global Corporate Bonds[3]	Global Government Bonds[4]	U.S. Direct Property (NCREIF)[5]	U.K. Direct Property (MSCI/IPD)[6]	Canada Direct Property (MSCI/IPD)[7]	Australia Direct Property (MSCI/IPD)[8]	Japan Direct Property (MSCI/IPD)[9]
1 Year	9.1%	-17.3%	5.5%	3.5%	2.0%	-3.2%	-0.5%	0.9%	5.0%
3 Years	8.4%	0.3%	5.1%	4.3%	5.1%	2.2%	4.4%	6.5%	6.1%
5 Years	10.9%	3.6%	5.0%	3.3%	6.3%	4.1%	5.4%	8.7%	6.8%
10 Years	10.8%	7.0%	4.7%	3.4%	9.4%	7.1%	8.3%	9.6%	5.9%
20 Years	5.1%	8.8%	5.7%	4.1%	8.3%	6.9%	9.3%	9.9%	—

*Stocks, REITs, bonds, and private real estate data are through 2020:Q3, except in Japan, where data are through 2020:Q2.

Note: The information shown is based on the research and market analysis of LaSalle Investment Management, and does not constitute a guarantee with respect to performance.

Notes on Sources
1. MSCI All Country Gross World Total Return Index in local currency.
2. S&P Global Developed Index in U.S. dollars.
3. Citigroup World Corporate Bond Index Total Return in U.S. dollars (local currency history not available prior to 1999).
4. Citigroup World Government Bond Index All Maturities Total Returns in local currency.
5. U.S. NCREIF Property Index Total Returns in U.S. dollars.
6. U.K. MSCI Quarterly Standing Property Total Returns in British pounds; data prior to December, 2001 is MSCI Annual. U.K. MSCI Quarterly Index used in all time periods available.
7. Canada MSCI Quarterly Standing Property Total Returns in Canadian dollars.
8. Australia MSCI Quarterly Standing Property Total Returns in Australian dollars.
9. Japan MSCI Quarterly (Based on monthly index) Standing Property Total Returns in Japanese yen.

Suwanee Distribution Center, Atlanta, United States

degrees of inflation/deflation protection, along with an equity-like residual payment that is anchored by replacement cost and market dynamics at the time of sale. This anchoring provides a hedge against price index (CPI or PPI) volatility and shares the characteristics of other "real" assets. The asset class also has experienced rapidly rising transparency as more high-frequency data becomes available to real estate managers.

- **Large asset class:** After stocks and bonds, real estate represents the third largest repository of the world's wealth. When residential real estate is included, real estate's size is comparable to the size of the entire corporate bond market. Our most recent investable universe indicates that income-earning real estate represents approximately one-sixth of the world's real estate assets (see LaSalle 2021 Global Real Estate Universe below). As investment-grade corporate and sovereign bond yields fall to closer to zero—$18 trillion or 26% of all bonds are negative yielding[2]—real estate's positive yield looks more attractive to pension funds and retirees.
- **Stability and low volatility:** Approximately two-thirds of the long-term returns from equity real estate come from the income component of returns, which typically exhibits bond-like stability. This ratio is even higher for real estate debt investments where the investor is typically well-insulated from changes in collateral value. Although the capital value component of income-earning properties delivers more volatility to private equity investors, both transaction- and appraisal-based real estate returns exhibit a Sharpe ratio comparable to securitized asset classes like stocks, convertible debt, and investment-grade bonds. Even though the growth prospects for real estate income took a step backward in 2020 due to the pandemic, the discount rate used to value these income streams also fell. The net result has been value stability for all but the most affected sectors like hotels and regional malls.
- **An accessible asset class:** Real estate investment vehicles have increased in number and offer both institutional and individual investors many more options than in the past. Whether held in a securitized vehicle,

2 Source: Barclays Global Aggregate Bond Index, November 2020.

LaSalle 2021 Global Real Estate Universe

U.S. $4.6 trillion
Public Real Estate (GAV)

U.S. $10.2 trillion
Institutional-Owned

U.S. $58 trillion
Total Income-Producing Real Estate

Defining the Universe	
Public Real Estate	The gross asset value of real estate owned by REITs and REOCs listed on public exchanges. Includes vertically-integrated development companies in emerging markets, but not exclusive homebuilders or infrastructure REITs.
Institutional Invested Real Estate	The unleveraged total value of all professionally managed real estate portfolios, both public and private.
Total Income-Producing Real Estate	Value of existing stock of all commercial (office, retail, inductrial, alternatives) with the potential to be income-generating and all currently rented residential buildings. Owner-occupied residential homes, infrastructure, and agricultural land are not included

Sources: Oxford Economics, Citigroup, Bloomberg, NCREIF, MSCI, Investment Property Forum (UK), National Bureau of Statistics of China, U.S. Bureau of Economic Analysis, U.S. Federal Reserve, and company financial statements. The public universe reflects estimates as of 2020:Q2. The institutional-owned and total-income producing estimates are for year-end 2020.

like a listed REIT, or in a private equity fund, real estate retains all of its characteristics over a medium- to long-term horizon (see Channels to Access Real Estate below).

Today, a diverse range of investment vehicles and risk-return approaches can be used to build a real estate portfolio, compared to 20 years ago. An investor employing a higher risk strategy should look for development, redevelopment, distressed assets, repositioning, and renovation opportunities. A well-balanced strategy may include value-add and opportunistic investments structured to deliver different performance relative to core investments across the business, credit, and property cycles.

Specialized property types that require operational expertise are growing faster than core property types. Investments in data centers, cell phone towers, healthcare facilities, hotels/resorts, social housing, senior housing, student accommodations, laboratories, single-family homes, and furnished apartments will alter the risk-return mix of a portfolio and increase the diversification of real estate income streams. By analyzing each subsector relative to the five reasons listed in The Case for Real Estate on page 58, real estate investors should focus on investing in hard assets capable of generating secure income. The asset class "case" weakens considerably when investing in real estate operating businesses with risk profiles that behave more like venture capital or other forms of public/private equity. Likewise positions in emerging "proptech" companies will have more in common with other venture capital investments than with real estate.

Debt Strategies

As pension plans and other forms of retirement savings schemes mature, they become more reliant on this income to pay out a stable benefit to their participants. The twin "black swan" events in 2020—a pandemic, followed by a global recession—have come at a time when investment-grade yields on fixed income and dividends on large-cap stocks are both at record lows. As a result, investors may be looking for real estate to generate the same or higher levels of dividend income, just as the yields in other asset classes are falling. Real estate debt instruments are a logical place to find this income.

Many real estate investors are making debt investments alongside real estate equity allocations for exactly this reason. Debt is a defensive stance when capital value downside seems as, or more, likely than upside. Mature pension funds also have a preference for contractual income secured by pools of collateral that would otherwise be difficult to assemble in an equity program. Like real estate equity, there are many styles of real estate debt investment, delivering different mixes of risk and return. Where a debt strategy fits on the risk-return spectrum will determine how various economic scenarios will affect investment performance. Regardless of this positioning, the overall risk/return trade-off of debt is different than equity, which can make real estate debt a useful complement in a diversified portfolio.

Real estate debt investment ranges from traditional low loan-to-value (LTV) senior mortgages to mezzanine and structured "special situation" investments that target higher return and risk. Traditional mortgages have a risk

Channels to Access Real Estate (Debt and Equity)

Channel	Summary Definitions
Direct	An investor buys and holds real estate investments utilizing mostly in-house expertise and capabilities (see also Separate Accounts below).
Real Estate Securities	Exchange-traded operating companies or REITs, with underlying assets backed by physical real estate assets.
Commingled Fund*	A vehicle that pools capital from various sources. Managed by a real estate investment manager and set up as a perpetual life vehicle (open-end fund) or a finite-life vehicle (closed-end fund).
Fund of Funds*	A commingled fund established to acquire interests in other commingled funds.
Joint Ventures (JV)*	A partnership between a real estate operator and a single capital partner, typically to acquire a property or properties.
Clubs*	A partnership between a real estate operator and multiple capital partners to acquire and manage a property.
Co-investment*	A partnership between a commingled fund and a capital partner(s) whereby the capital partner provides a portion of the equity capital to acquire a property(s), typically because the capital requirement is too large for the commingled fund.
Separate Accounts	An investment vehicle set up for a single investor by a dedicated third-party investment manager. This type of account can invest in any combination of direct, indirect, public, private, debt, and equity as agreed between the investor and the manager.

*Together commingled funds, funds of funds, club joint ventures, and co-investment approaches can be termed "indirect."

Source: LaSalle Investment Management.

profile similar to investment-grade, fixed income instruments and many institutions consider them as such. By contrast, the higher risk/higher return part of the market is driven by non-traditional real estate lenders (NTRELs) who are not part of a traditional banking institution.

These NTRELs broadly use the following three methods to generate more return than a traditional mortgage:

- Lending at higher LTV ratios on the underlying asset, either in a whole loan or a mezzanine loan form.
- Lending against assets undergoing renovation or being developed, increasing the risk around the underlying collateral.
- Leveraging the loan portfolio by borrowing a part of the capital used to make the loan.

Many NTRELs utilize a combination of all three options. There are also tweaks to other lending terms that can boost returns, such as recourse provisions, capitalization of interest, and access to more future borrowing, if values or net operating income improve.

With so many structuring options, it is difficult to characterize all NTREL performance in the same risk-return category to know exactly how each debt strategy will perform under different economic and market conditions. There is also limited historical return data and/or broad-based experience on the functioning of some structures during downturns. However, previous experience in a downturn can be more important than a robust data set. We believe that these are some of the most important attributes of an effective debt strategy: 1) close underwriting of the underlying collateral; 2) a willingness to intervene when business plans go wrong; 3) retaining a significant “at risk” position even when leveraging underlying loan portfolios; 4) careful project selection and borrowers with successful track records; and 5) lending where the largest pools of debt capital (usually banks and insurance companies) are absent.

Senior debt investment will be a solid return generator for investors navigating both stable and moderate downturn environments. Mezzanine positions are more vulnerable if they were secured prior to the pandemic. However, as bank capital becomes less available and asset values reset, the mezzanine market in 2021 will likely shape up as a market where higher yields can be earned, even with much more conservative underwriting as the global recession is still going to be a factor. Economic and real estate market conditions would need to deteriorate more to impact debt returns compared to equity investments. The trade-off for receiving more durable returns from debt is that the upside is limited and asset impairment can be rapid in mezzanine positions once value thresholds are breached.

The current economic outlook for recession conditions in the first half of 2021, followed by a robust recovery in the second half, supports the inclusion of debt investments in real estate portfolios. These investments can help diversify a portfolio as their performance will not move in tandem with equities, thus helping to smooth performance across market cycles. The limited upside of senior debt is less of a negative in a volatile phase of the cycle when appreciation going forward is unpredictable.

In summary, there are many varieties of debt investments and investors should evaluate which methods are being used to enhance returns and to what degree. A balanced strategy across LTV levels, asset status, and step-in rights could produce durable performance in mildly adverse market conditions. The mezzanine debt markets, like the equity markets, are becoming more efficient as they grow. The pandemic revealed which lenders are sailing too close to the wind, many by leveraging their already risky positions. In 2021, the more prudent debt funds will take advantage of the gaps in the capital markets opened up by the pandemic and the failures of the most aggressive lenders.

Accessing the Real Estate Investment Universe in 2021

Each year, LaSalle’s research and strategy team estimates the size of the income-producing real estate universe by country and by segment. Our analysis shows that, as of the end of 2020, institutional-owned real estate totals ~$10.2 trillion, a 4% decline from a year ago. The modest reduction in value is due to the pandemic, but the value decline is also offset by the continued migration of properties from non-institutional categories to professionally managed asset pools, as well as new development and redevelopment. There are many ways

State and Grand, Chicago, United States {click on photo for video tour)

111 Emerald Hill, Singapore

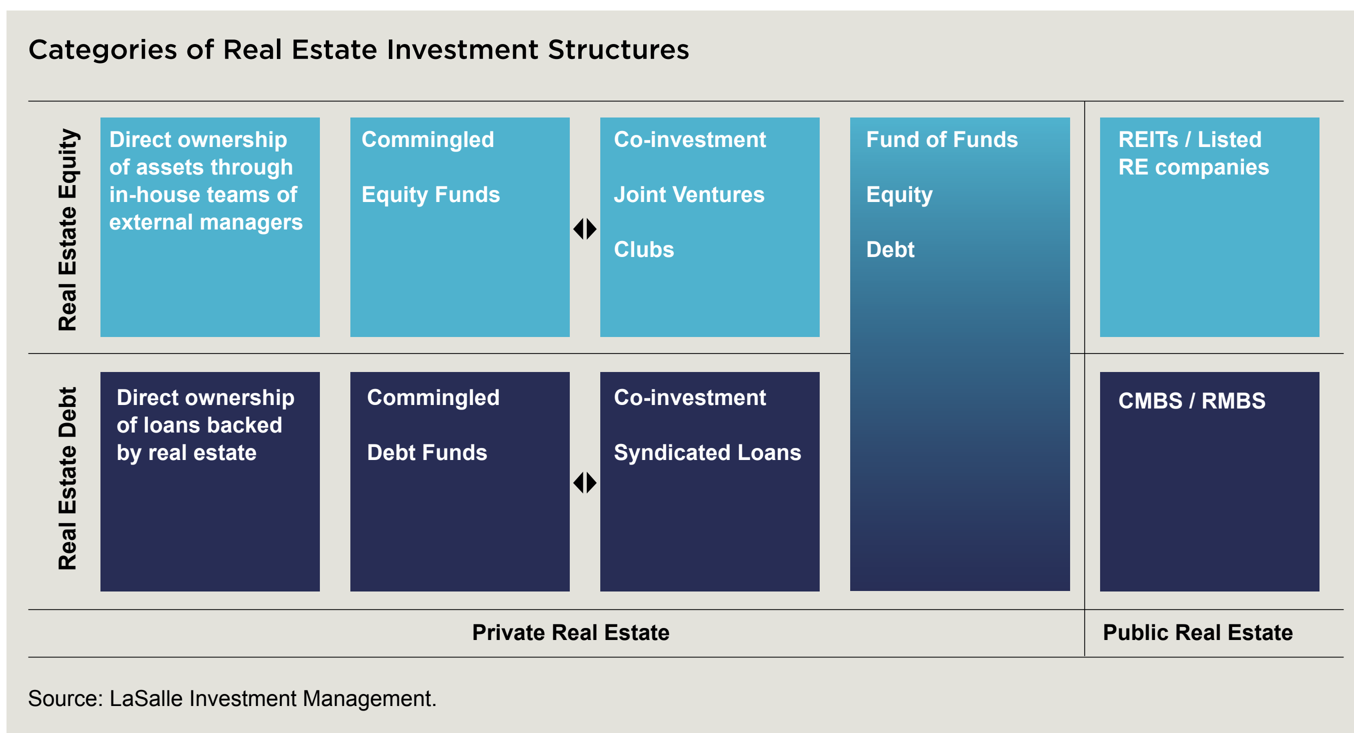
for investors to access the real estate opportunity set. Tools like the real estate universe estimates show investors where the channels of access overlap with the underlying opportunity set. This is a first step in designing a global investment strategy targeted toward desired performance objectives.

One of the key characteristics of real estate is its high and rising degree of accessibility. The number of real estate investment vehicles has risen, creating a wide array of options for both institutional and individual investors. In the table Channels to Access Real Estate (Debt and Equity) on page 60, we summarize the main ways to access real estate and each channel's characteristics. While the multitude of structures and vehicles adds complexity, the diversity of offerings is also a positive feature. Investors can select a structure designed to provide a balance between the control, liquidity, diversification, and size of the investment.

Despite all the different structures, they have common underlying characteristics. For instance, the academic literature shows that, even with higher short-term volatility, real estate security performance approximates direct real estate over longer periods. Nevertheless, the financial structure does alter the upside/downside characteristics and liquidity of any given real estate investment. For example, investors can access real estate debt in public markets through commercial mortgage-backed securities (CMBS), and in private markets through commingled private debt funds, indirect and multimanager channels, as well as through separate accounts. Similarly, equity-like returns from real estate are available to investors through public market vehicles (REITs and property companies), as well as private markets through any combination of separate accounts, commingled funds, and indirect approaches. Categories of Real Estate Investment Structures below illustrates nine broad channels of access for real estate investors.

Portfolio Balance

The nine approaches mentioned above carry relative benefits, constraints, and varying degrees of complexity. Investors will face inherent trade-offs when choosing a combination of vehicles that will fit well in their investment strategy. For 2021, the brisk rise of alternative property types and the rapid changes in the institutional



Source: LaSalle Investment Management.

Relative Advantages of Different Real Estate Investment Structures

	Control	Liquidity	Ease of Execution	Diversification	Access to Higher Returns	Access to International	Access to Niche
Securities	5	1	1	1	4	1	1
Fund of Funds	5	4	2	1	2	1	2
JV / Club / Co-investment	3	5	3	2	1	1	2
Commingled Funds	4	3	3	3	3	2	4
Core	4	3	2	2	4	2	4
Non-core	4	5	4	3	1	2	4
Debt	4	5	4	3	3	3	3
Separate Accounts	2	2	5	3	1	3	3
Direct Investing	1	2	5	4	1	3	3

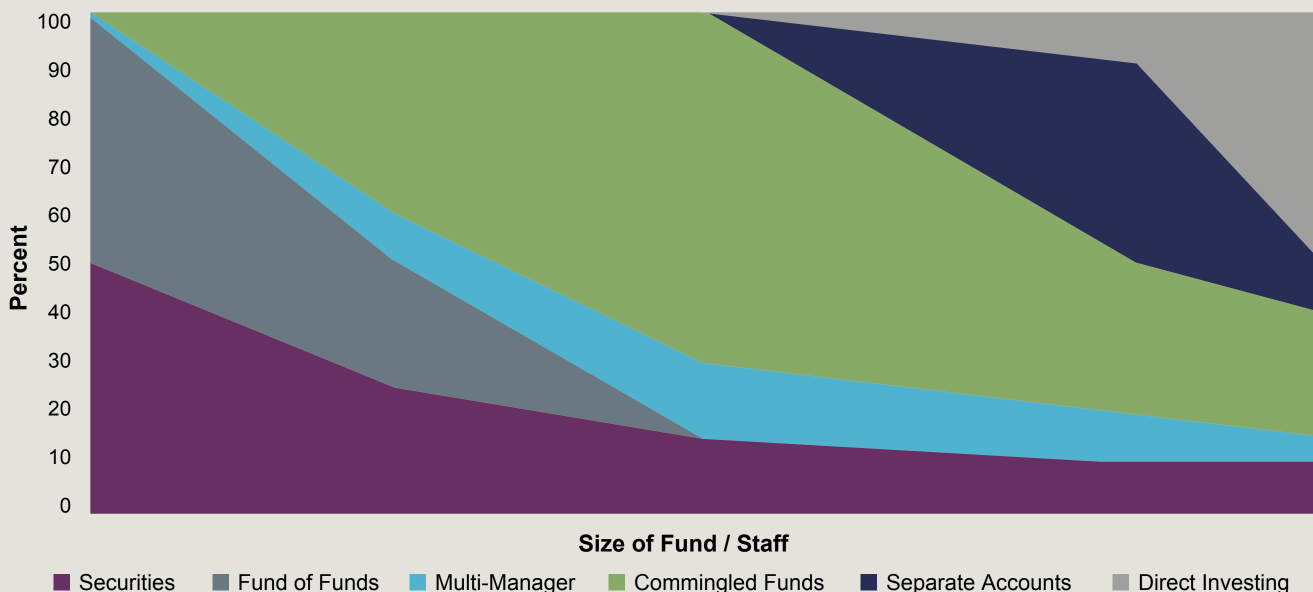
Highest 1 2 3 4 5 Lowest

Source: LaSalle Investment Management.

benchmarks used to measure performance require a close understanding of which categories will work best for highly-specialized property types, and those that will work better for more traditional property types. The table Relative Advantages of Different Real Estate Investment Structures above provides the relative attributes of the various investment structures. This table highlights that in contrast to commingled funds and direct ownership, real estate securities and various indirect approaches provide a comparatively simple tactic for investors seeking access to international and niche-sector real estate.

The model shown in Indicative Mix of Real Estate Investment Vehicles by Investor illustrates how investors are well-served by building a real estate portfolio using concurrent approaches. Smaller investors, despite possible resource constraints, can still achieve a diversified and professionally managed exposure to real estate by using a combination of real estate securities and

Indicative Mix of Real Estate Investment Vehicles by Investor Size



Source: LaSalle Investment Management.

Zenith CS, Pinghu, China

multimanager routes. Even the largest institutions often retain external expertise via separate accounts, commingled funds, multimanager or external securities, alongside internally-managed assets. Larger investors with an allocation to real estate that is well over $1 billion display a greater preference for direct investments and separate accounts than smaller investors, whereas commingled funds are more commonly sought by investors whose real estate allocations are under $1 billion. Securities or non-exchange-traded REITs (especially daily NAV REITs) work best for individual investing less than $1,000,000.

Many institutional investors consistently report that they are under-invested in real estate relative to their target allocation[3] due to the lack of suitable assets that achieve targeted returns. Yet our real estate universe estimates show that institutionally-owned real estate only comprises about 20% of all income-producing property. The migration of properties from entrepreneurial or family ownership to institutional, professional management still has an incredible journey ahead. Our Summary Table indicates where professional management has made the greatest progress and where the markets are dominated by corporate-owned or family-owned assets.

The process of "institutionalization" involves many steps as more types of specialized real estate migrate from developer/founder-controlled entities to investment vehicles with professional management. These steps include setting up systems for fiduciary governance, aligning management interests with investor interests, and reporting on financial performance alongside a growing focus on meeting environmental social governance (ESG) goals. All of these steps take time and effort to implement. In the post-COVID-19 era, we are likely to see an acceleration of specialized asset categories joining, and even supplanting, traditional property types in professionally managed real estate portfolios in the coming years.

PREDICTABLY UNPREDICTABLE

The macro-economic, political, and social outlook that sets the stage for investment plans and strong performance are the focus of the *Investment Strategy Annual*. The pandemic and the ensuing global recession raise the importance and difficulty of these tasks. Even as vaccine distribution gets underway, it will be many months before inoculations are readily available to the general public and economies are restored to their prior strength. During this COVID-19 "end game," our advice to investors is to focus on these five themes:

1. Expect the dispersion of returns to continue.
2. Invest in the rise of alternatives.
3. Anticipate changing mobility and density preferences.
4. Separate permanent from temporary shifts.
5. Balance three styles: growth, income, and dislocation.

The first four themes are addressed in the first two chapters of the *ISA*. The fifth item is about portfolio construction. In past years, we have developed global model portfolios that presume a generic investor without any domestic bias or currency/tax concerns. Over time, we realized that none of our clients fit this description, so we have omitted this section. Instead, we welcome the opportunity to work in a customized way with any client needing help with portfolio strategy.

While COVID-19 is still raging, it may seem pointless to speculate too much about the future. But, for fiduciaries, entrusted with the assets of others, taking a view on the outlook for 2021–23 is a necessity, not an option. An investment manager's task is not to predict the future precisely. Instead, we must balance risk and return without having perfect foresight. That means pursuing investments and positioning portfolios to perform well, without knowing for sure when the pandemic is brought under control or exactly how societies and economies will respond. More important than perfect forecasting ability is an explicit macro-economic and thematic framework to help portfolio managers filter and recognize opportunities when they turn up. Deal flow, like the pandemic itself, is inherently unpredictable. Strategic preparation in advance, though, can be disciplined, thorough, and predictable.

3 Hodes Weill & Associates 2019 Real Estate Allocations Monitor.