



Avenue Living



Private REIT Performance Relative to Their Public Peers

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The Value of Alternatives

The concept of hard assets as stores of wealth in an inflationary environment seems intuitive — but it wasn't until 1984 that concrete evidence was offered to prove the case¹. In Miles & McCue's research, they show that capital appreciation of real estate investments has historically outpaced the rate of inflation². While real estate can provide a hedge against inflationary pressures, it also provides a route to diversification from other more established investment vehicles such as stocks and bonds.^{3,4}

According to a survey by the Bank of Montreal, as of 2020 77% of Canadians held personal investments⁵, with the vast majority investing in conventional investments comprised primarily of stocks, bonds, and cash⁶. As a portion of a portfolio, alternative investments — unlike stocks, bonds, and cash — can offer a counterbalance to offset overall risk. Additionally, these alternative investments are less correlated to the public markets, allowing the holder to avoid the trap of concentration risk. The most held forms of alternative investments include commodities and real estate.^{7,8}

Investing in real estate can mean varying things to different investors. To the everyday investor, direct private ownership is the most obvious form of real estate investment. In this approach, an individual purchases a property to rent out, using the rental income cash flow to generate returns. However, barriers to entry have emerged for direct owners from a supply-and-demand standpoint. Current property prices have increased the debt burden, and a trend toward asset consolidation means that individuals looking to directly own assets are often limited to older, less desirable stock. In turn, renters have come to expect a higher standard of professional services and an enhanced rental experience. For the average investor who is not a professional landlord, indirect ownership provides the benefit of side-stepping the responsibility of managing, maintaining, and owning the physical property, while leveraging institutional expertise in ownership and management to maximize yields.

Indirect Real Estate Ownership

As Figure A demonstrates, both indirect public ownership and indirect private ownership models offer a unique opportunity for ordinary investors to not only hedge inflation through a trusted hard asset class but also benefit from a professional owner-operator managing and maintaining the asset. Professional ownership and management allow everyday investors to maximize the economies of scale, footprint, and diversification of their investments. Both indirect forms of ownership utilize the buy-in structure of share purchasing through a fund or index, which is itself the asset owner. Public ownership entities tend to be reputable and well-known, but the market value of their equity tends to be heavily correlated with broader public market indices (Figure A). Private ownership entities are generally less well known than their public peers, but they can offer a respite from traditional public market offerings through an alternative asset class with professional ownership and management.

Figure A: The Property Ownership and Investment Spectrum

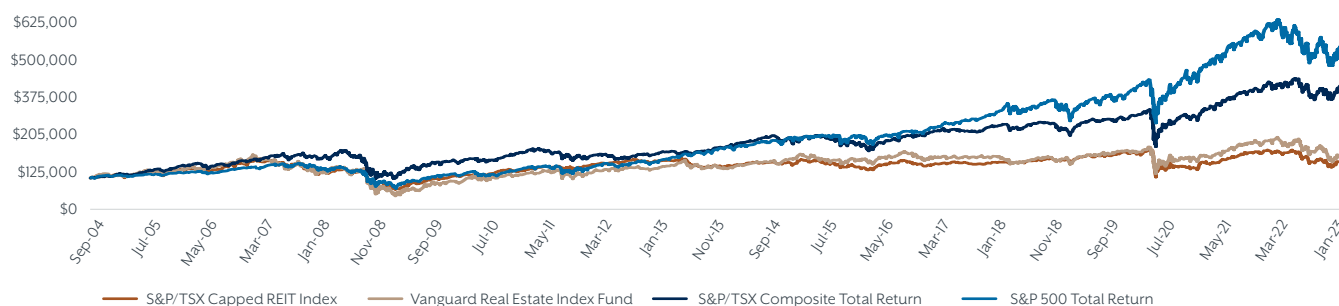
DIRECT PRIVATE OWNERSHIP	INDIRECT PUBLIC OWNERSHIP	INDIRECT PRIVATE OWNERSHIP
Direct ownership of an investment property	Indirect ownership (beneficial) of the underlying properties	Indirect ownership (beneficial) of the underlying properties
The individual is the asset and property manager (individually accountable to residents)	Professional asset and property managers	Professional asset and property managers
High risk / high reward	High liquidity via the secondary market of the public exchange, producing higher relative volatility, as result	Reduced liquidity as compared with the public markets (redemption notice period), producing lower relative volatility
Highly illiquid (requires the sale of asset)	Generally, strong correlations with the broader indices	Generally, weak correlations with the broader indices
Directly correlated with the residential housing market		

Source: Avenue Living Asset Management Internal Data

The rationale driving share ownership in a publicly traded REIT is twofold; hedge inflation and offer diversification from traditional public market offerings such as stocks and bonds. One might then expect that public REIT performance does not march in lock step with other public market offerings. Contrary to this notion, Figure B maps a selection of the most widely traded real estate offerings on the public markets against the broader S&P 500, acting as a proxy of the broader public market. By conducting a correlation analysis between a collection of major real estate-centric indexes and exchange-traded funds; S&P/TSX Capped REIT Index, Vanguard Real Estate Index Fund, iShares US Real Estate ETF, versus the S&P/TSX Composite Index, and the S&P 500, performance between publicly traded real estate entities and funds are tightly correlated with the broader public market. By investing in indirect ownership, an individual should seek to leverage Net Asset Value (NAV) gains, which are defined as a function of (assets - liabilities) divided by total shares outstanding. Investing in a real-estate fund ought to generate asset value appreciation at a faster rate than liabilities, which results in share appreciation.

Indirect private ownership performance is therefore linked to asset performance. Indirect public ownership performance, however, is intricately linked to broad market performance. As shown in Table A, correlations are drawn between both the S&P/TSX Composite Index and the S&P 500, representative of the broader public markets, against each of the above real estate-centric indexes and exchange-traded funds. The correlation analysis consistently shows correlations of >50%. Generally, when a correlation between two variables is >40%, the correlation is considered strong⁹.

Figure B: Since 2004 REITs in public equity markets have had a high degree of correlation to the broader indexes



Source: Avenue Living Asset Management Internal Research and Analysis, YCharts

Table A: REIT Equity Historical Correlation from September 2004 to September 2022

CORRELATION	S&P/TSX CAPPED REIT INDEX	VANGUARD REAL ESTATE INDEX FUND	S&P/TSX COMPOSITE TOTAL RETURN	S&P 500 TOTAL RETURN
S&P/TSX Capped REIT Index	1.0			
Vanguard Real Estate Index Fund	0.55	1.0		
S&P/TSX Composite Total Return	0.60	0.60	1.0	
S&P 500 Total Return	0.54	0.76	0.80	1.0

Source: Avenue Living Asset Management Internal Research and Analysis, YCharts

Table A, correlations are drawn between both the S&P/TSX Composite Index and the S&P 500, representative of the broader public markets, against each of the above real estate-centric indexes and exchange-traded funds.



An Option for True Diversification: Indirect Private Ownership

While indirect public ownership options appear to be closely coupled with broader publicly traded funds and indices, private indirect ownership options do not operate under the same fundamentals, and therefore offer true diversification. Public market options — whether they be individual REITs, funds, or indices — are valued on the market's expectations for performance rather than the NAV. This is in line with public stock values, where the focus is on earning potential and net asset values growth, therefore acting as a leading indicator for value¹⁰. Conversely, for indirect private ownership, valuations are based on underlying fundamentals, i.e.: real estate asset performance¹¹. Private options are valued on proven market performance when it comes to earnings and net asset value growth, therefore acting as a lagging indicator.

Indirect private ownership offers an entry point that is valued based on recent past performance, therefore representing a timely and realistic snapshot of asset performance. However, indirect private ownership is not without drawbacks. Shares of private funds are not as liquid as public options, where shares can be bought and sold like an individual stock on public markets. The indirect ownership approach is, however, far more liquid than direct ownership, where a hard asset cannot be disposed of rapidly. Additionally, private funds must be managed with the risk of redemptions. Redemptions negatively impact a fund's equity position — these impacts must be understood and minimized by management.

The Benefits of Diversification

While both public and private indirect ownership options offer an alternative to direct ownership as an avenue to real estate investment, leveraging the professionally managed efficiencies of institutional players, they offer differing exposures. As part of a balanced investment portfolio, private indirect ownership can offer an alternative to the fluctuations of public markets, as public indirect ownership performance is strongly linked to public performance¹². The value of private indirect ownership is not only a diversification play against the public market, but one that is based on the fundamentals of a hard asset, underpinned by sound professional ownership and management. Public indirect ownership through funds or indices fails to offer a hedge against public market risks, and therefore remains a worthwhile inclusion within a balanced mixed-asset portfolio, but it ought to be considered as a public market investment rather than an alternative. Private indirect ownership is a complementary product — one that offers a different valuation methodology and a broader hedge against turbulence in public markets.

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