Manulife Investment Management

Real estate: the role of diversification in pursuing outperformance

Erin Patterson
Global Co-Head, Manulife Real Estate Investment Research and Strategy

Cornelia Le
Director, Canada, Manulife Real Estate Investment Research and Strategy

The investment environment today faces formidable but not insurmountable headwinds that challenge the performance of commercial real estate (CRE). As CRE returns are driven by income production, in a universe where investable assets are evolving, strategic sector selection and diversification are critical to achieving optimal performance while balancing risk. Whereas sector diversification within U.S. core/core-plus CRE funds is a recognized strategy, the majority of institutional investors deploying capital in Canada are only beginning to explore entry points into alternative and niche sectors. While today's economic environment certainly puts Canada's CRE performance into question, notably, Canada's CRE returns have generally outperformed those of the United States over the last 25 years.[1] The diversification into select alternative sectors today may offer more resiliency in future economic downturns, given their countercyclical qualities. Although these sectors tend to be more operationally intensive, the right asset manager should be able to mitigate these challenges through experience gained by navigating across both regions through multiple economic cycles.

Canada's economy signaling structural strain

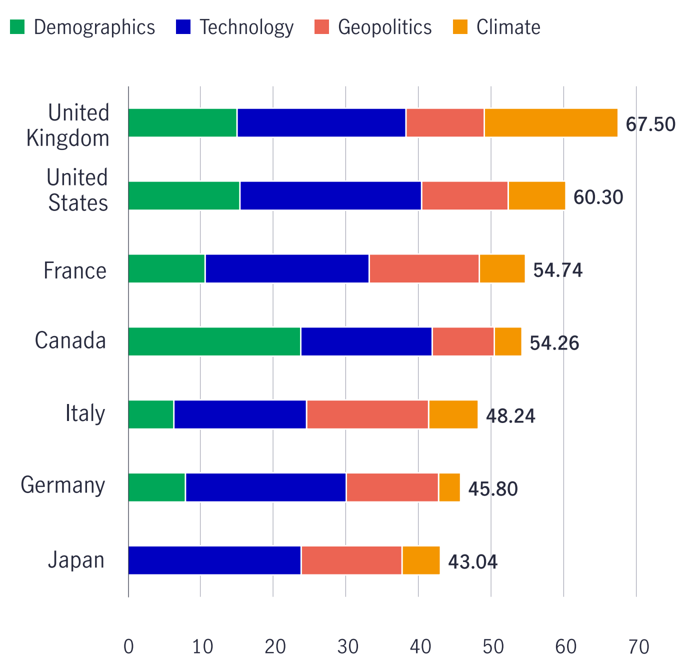
As of August 2025, Canada's macroeconomic landscape reflects a multifaceted but evolving environment that underscores the importance of diversification in CRE portfolios to mitigate risk. Inflation continues to trend toward the Bank of Canada's 2.0% target, with headline CPI easing to 1.7% year over year—its lowest level in over two years.[1] However, inflationary pressures may resurface in the near term as the effects of ongoing trade tensions gradually filter through to retail prices.[2] Underlying risks persist, including the broader economic impact of ongoing trade tensions. GDP growth showed resilience in Q1, boosted by inventory accumulation. While subsequent negative monthly data suggested potential recession, and Oxford Economics previously categorized the economy as having entered a trade-tension-induced recession, concerns around a full-blown recession have not come to fruition.[2]

Canada's labor market is beginning to show signs of systemic weakness. August payrolls posted a loss of 65,500 jobs following a 40,800 decline in July. The unemployment rate rose to 7.1%—the highest since 2016 (excluding the pandemic)—despite lower labor force participation.[2] Wage growth slowed to 1.1% year over year, the weakest pace in over four years, reflecting easing labor market pressures and softer demand amid slower economic growth.[3] Importantly and ironically given the low participation rate, the rise in unemployment was driven more by new labor force entrants than by layoffs. At the same time, participation remains below year-ago levels and business confidence continues to erode.[4] Job losses have broadened to less directly trade-exposed sectors and were primarily concentrated in part-time and self-employed positions. Employment declined in the trade-oriented manufacturing, transportation, and warehousing sectors, as well as in service-producing sectors.[5] With forecasts projecting further job losses and unemployment escalating through year end, alongside record levels of condo supply delivering, there's a softness in traditional CRE sectors such as residential and industrial, making diversifying into alternative real estate sectors—specifically those less correlated with traditional economic cycles—an increasingly compelling avenue for investors seeking stability, income resilience, and long-term value creation.

Performance potential despite limited market depth

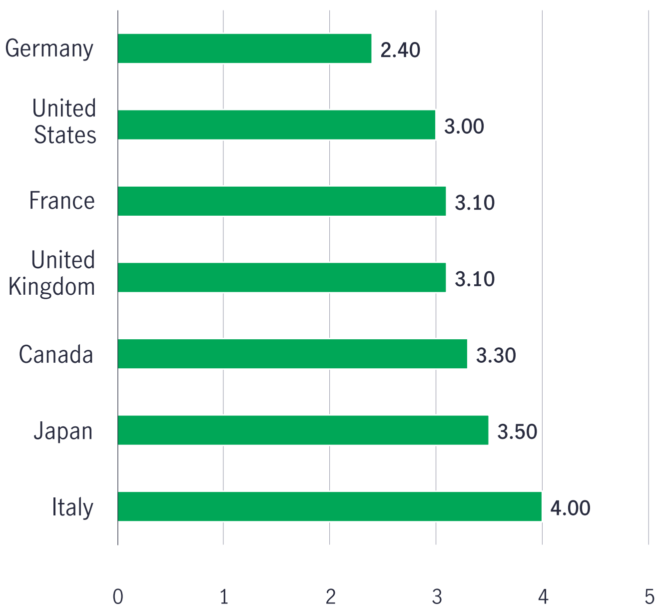
Over the past two decades, Canadian CRE has outperformed a few global peers, particularly in terms of volatility-adjusted returns, largely due to stability across CRE financing. Canada's historically strong CRE performance is often counterbalanced by the size of the market (roughly a quarter of the U.S. market), with an approximate valuation of CAD$165 billion.[1] While the United States CRE market value has grown 16x since 2000, Canada's has tripled. Canada also has fewer major or gateway markets, which, combined with foreign buyers' tax implications related to exit, attracts a more limited number of institutional cross-border investors. Domestic institutions account for a large share of Canada's CRE market, attracted to political stability, low debt-to-GDP ratios, and a less pronounced boom-bust cycle than in the United States. Among its G7 peers, Canada ranks fourth on the Oxford Economics CRE Megatrend Resilience Index, which aggregates demographic, technological, geopolitical, and climate factors. Canada's competitive edge lies in its strong demographic tailwinds, which are expected to support sustained growth across multiple CRE sectors.

CRE megatrend resilience index (all property scores)



Source: Oxford Economics. Data is as of September 2024.

Economic risk index (10=highest)



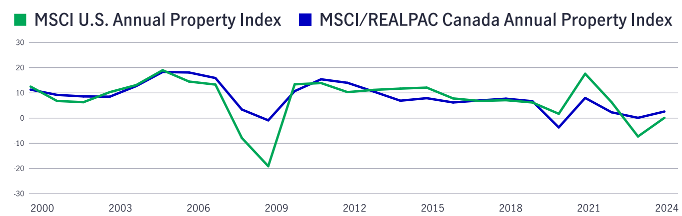
Source: Oxford Economics. Data is as of April 2025.

Canada's Economic Risk Index remains low at 3.3, ranking 27th out of 164 countries and 5th among G7 peers, which is broadly in line with the average for advanced economies. The index incorporated factors such as market demand, market costs, exchange rate, sovereign credit, and trade credit. This relatively low risk profile will continue to attract foreign investors who view Canada as a stable destination for long-term CRE investment amid global uncertainty.

Canada's CRE investment market has historically been dominated by private domestic investors in major markets, and the last two years have been no exception. In fact, the share of private investment increased significantly, accounting for more than half of transactions, compared with the previous decade.[6] Accompanying more active domestic private buyers is a retrenchment in global capital inflows to Canada, totaling CAD$2 billion in 2024—the second-lowest annual level in the last decade.[6] Moreover, investment dollars target a limited universe of markets: Toronto, Vancouver, and Montreal were the beneficiaries of the vast majority of investment dollars, receiving more than twice as much as other markets over the last three years.

Despite a lack of institutional and cross-border investment activity compared with the United States, Canada's CRE performance shows considerable resilience, and overall, has outperformed. According to MSCI, Canada's total returns have averaged 80 basis points (bps) higher than the United States since 2000, at 8.3%. However, over the last five years, U.S. CRE performance has gained ground, averaging 3.7% compared with 1.9% in Canada.[1] Industrial and multifamily properties are rooted in much of this growth, but the expansion into alternatives in core/core-plus funds has further advanced portfolio performance. In fact, over an even longer period, NCREIF Property Index (NPI) returns for the United States show alternatives outperforming traditional sectors by more than 300bps over the last decade.[7] And even as U.S. returns across both traditional and alternative sectors fell into negative territory during 2023 to 2024, alternatives outperformed.

Annual total returns–traditional real estate (%)



Source: MSCI. Data as of Q2 2025. Past performance is not indicative of future results.

Income returns take the lead in a low cap rate environment

Just as increased allocation to alternatives may enhance portfolio performance through diversification, returns can also be positively affected through asset management and operational tactics that grow net operating income (NOI). Income growth has become an increasingly important driver of CRE returns since the Great Financial Crisis (GFC), accompanied by a reduction in the impact of cap rates. U.S. returns historically show a greater reliance on income returns than cap rates, driven by market appreciation. While Canada's returns have historically shown a greater impact from cap rates, reliance on income returns is still increasing, as expected during times of economic uncertainty. From 2001 through 2009, the average cap rate was 7.6% for both the United States and Canada. Following the GFC, U.S. cap rates compressed to a low of 5.3% in 2021 and Canada's compressed to a slightly greater degree, to 4.8%.[1] Since then, average cap rates in both countries have widened by about the same amount, but Canada's remains about 50bps lower at 5.5%, with a spread of about 100bps attributable to debt. This leaves even less room for compression and directs focus on investing in sectors with greater income appreciation.

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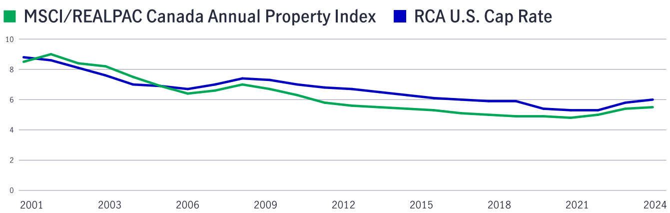
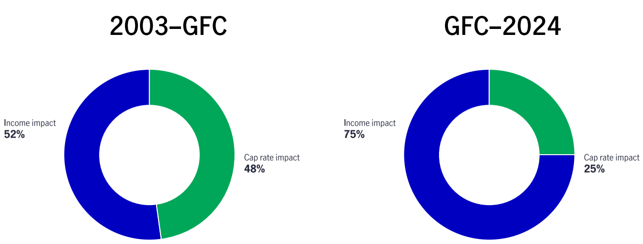
Cap rates (%)



Source: MSCI. Data is as of Q2 2025. Past performance is not indicative of future results.

In the period from 2003 through 2007, cap rate impact accounted for 48% of total returns in Canada versus 36% in the United States, while income returns accounted for the balance. Following the GFC through 2024, a dramatic shift occurred in favor of income, where the cap rate impact narrows to 25% and 19% of returns in Canada and the United States, respectively. Given that Canadian cap rates are only about 50bps to 70bps above their historical lows depending on the sector and have remained stubbornly low—virtually unchanged year-to-date through second quarter 2025—the potential for cap rate compression to drive meaningful upside in total returns appears limited.

Cap rate versus income impact on Canada CRE total returns



Source: MSCI. Data as of Q2 2025. Past performance is not indicative of future results.

With more rate cuts on the horizon, it's possible that cap rates could compress further, as the institutional-quality investable universe is limited; however, the margin of opportunity is thin. Investors can enhance NOI by selecting highly strategic sectors, markets, and assets, leveraging tactical measures through active asset management, strategic operating partnerships, and operational efficiencies. Today's economic backdrop, however, is challenging demand-side fundamentals and narrowing the range of strategic opportunities. Renters and consumers face persistent inflation and potential labor market dislocation; industrial occupiers are sidelined in decision-making while reconciling tariff impacts; and office users are still conservative in their leasing strategies, especially given a potential economic recession. This conundrum is leading investors to seek new sources of performance upside, including more diversification, that may not only help to mitigate risk and potentially boost performance in down cycles, but also offer greater flexibility to deploy targeted tactical measures supporting income growth—an increasingly critical driver of total return.

Alternative assets are expected to experience increased investor demand and become a more significant target of investment allocation moving forward, a trend already evident in the United States. As performance shifts in favor of income, incorporating alternatives into portfolio construction may provide an opportunity to tap into a broader array of operational approaches to advancing overall portfolio income growth. While challenging, when done with expertise, a deeper level of operational intensity allows for greater control over potential income growth and performance, including for some alternatives, especially during periods of economic headwinds.

Alternative sectors offer resiliency through innovation and management

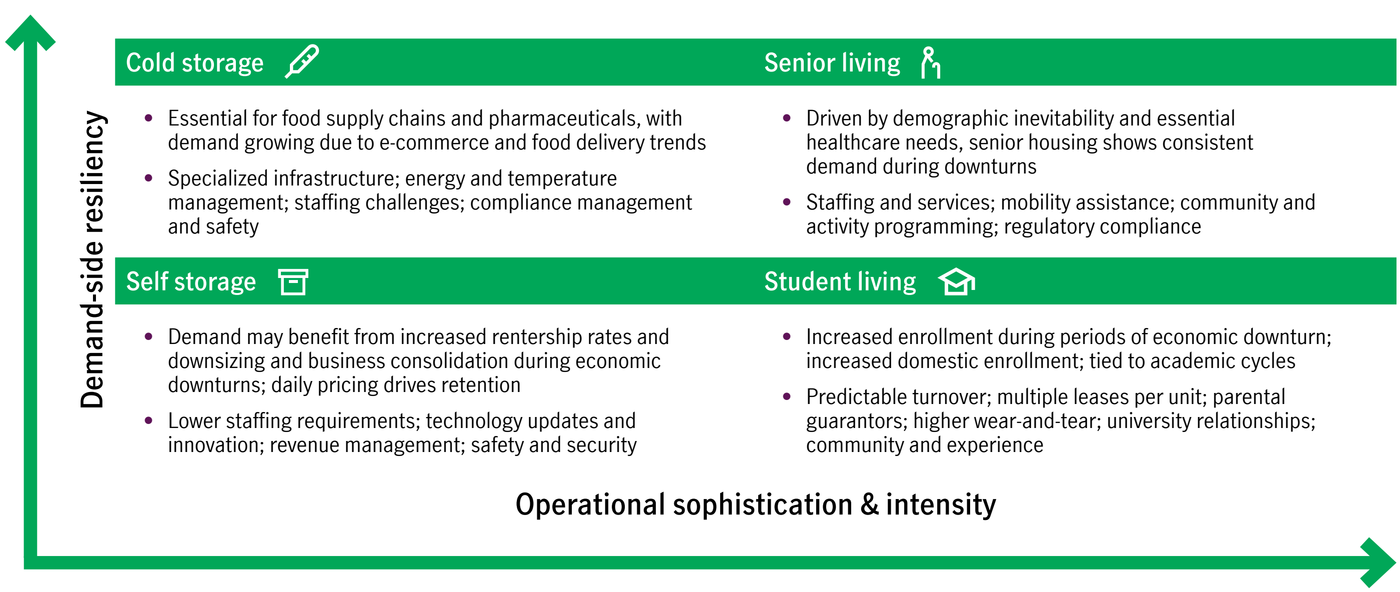
CRE has long been valued as a diversifier in investment portfolios, driving stability by acting as an inflation hedge, with less volatility and more countercyclical qualities in select asset types.[8] For instance, multifamily investment has been frequently leveraged to circumvent inflationary pressures through shorter lease rolls and more mark-to-market opportunities that allow owners to increase rents in line with inflation, and the sector also benefits from relatively inelastic demand compared with other product types. However, as Canada enters a recessionary environment in this most recent cycle, multifamily may not offer its previous countercyclical protections due to short-term oversupply, record high rents, and shadow inventory impact, coupled with changes to migration policies. As a result, investors are being forced to consider alternative strategies for maintaining portfolio resiliency during a downturn. According to PwC's Emerging Trends in Canadian Real Estate 2025, investment prospects were reportedly highest in several alternative areas, with data centers, student housing, medical office, and senior living among recommended buys.[9]

Alternative CRE may offer a twofold advantage, particularly given the emphasis on income growth to drive outperformance. A 2025 Preqin global survey revealed 50.3% of investors reported diversification in CRE as an inflation hedge.[10] Of the three key best bets highlighted in the Emerging Trends in Canadian Real Estate report, investment in niche assets is high on institutional investors' radar, calling out strong demand drivers and growth opportunities for student housing, cold storage, and select areas of senior housing.[9] Moreover, select alternative real estate may provide portfolio insulation during a recession and may be more liquid from an institutional perspective, since:

- Senior living demand is anchored in macro-demographic trends.
- Data centers benefit from the exponential rise in digital infrastructure needs.
- Cold storage is tied to agricultural production, medical products, e-grocer expansion, and supply chain resilience.
- Self-storage demand reflects urban density, housing affordability and consumer behavior.

These alternative sectors tend to be less correlated with economic forces that influence conventional core assets, and their demand profile is potentially more inelastic and, in some cases, more countercyclical compared with traditional CRE sectors.

While alternative CRE often demands specialized management and operational expertise, this complexity also enables greater control over income generation and ability to unlock strategic levers to strengthen balance sheets. In balancing resiliency and operational intensity, we believe four alternative sectors that may present investors the greatest potential for a strong risk-adjusted return in Canada are senior living, student living, cold storage, and self-storage. Each of these sectors boasts attributes that may help the sector weather economic distress through durable demand-side drivers, growing innovation, and operational tactics. These alternative sectors may require more sophisticated asset management and customized operational tactics to manage the nuances. All also feature more resilient and inelastic demand, relying on critical purpose, natural, lifestyle, and behavioral inputs that create durability, including aging, family formation, and generational preferences, among others.



Source: Manulife IM Real Estate Research. As of September 2025. For illustrative purposes only.

Though traditional CRE investment sectors can certainly benefit from enhanced asset management to drive overall returns, Canada's untapped alternative sectors offer an opportunity for institutional investors to balance risk against reward in a challenging part of the cycle. Moreover, the ability to leverage new technology in these sectors is great. We believe technology, AI, and automation will continue to drive innovation across all CRE sectors, and their integration into asset management is critical to maintaining a growth trajectory. For alternative sectors just emerging on Canada's institutional radar, early-stage investment offers a rare opportunity to integrate advanced technology at the platform level—laying a strong foundation for scalable growth.

The go-forward: balancing risk/return potential in untapped strategies

Looking ahead, the evolving risk/return dynamics in the CRE sector call for a more disciplined, creative, and diversified investment approach, with income stability likely taking precedence over capital appreciation. While core CRE sectors show visible signs of slowing and a lack of near-term growth catalysts, opportunities are increasingly found in complementary alternative sectors—those supported by long-term structural drivers that may be less dependent on traditional economic cycles.

In our view, diversification is no longer just a defensive strategy; it's emerging as a potential source of long-term outperformance. By reweighting portfolio construction toward sectors driven by demographic inevitability, structural supply constraints, and technological change, investors can enhance risk-adjusted return while reducing exposure to cyclical downturns.

As noted earlier, Canada's institutional exposure to CRE alternatives still lags the United States, and in part, may reflect limited CRE data availability and transparency. Even so, for select alternative sectors, demand drivers and supply dynamics are very clear and can provide visibility into potential performance. Parallels can be made to traditional sectors to estimate performance potential. For example, cold storage is a relatively fragmented alternative sector with limited data. However, demand drivers may include household formation, pharmaceutical or biotech investment, grocer e-commerce presence, and are measurable. Direct linkages to industrial can also be made to determine if a market is favorable for cold storage investment through infrastructure, regulatory aspects, supply or land availability, and labor force.

In the near term, we believe Canada's market will be defined less by expansion and more by rebalancing and market correction. Elevated interest rates, tighter credit conditions, and slowing economic momentum have made traditional return drivers, such as cap rate compression, far less feasible. Instead, we see investors increasingly prioritizing income stability and operational performance, naturally directing capital toward sectors with dependable cash flow profile. The current cycle is also pushing capital to explore alternatives, not as a fringe allocation but as a necessary component of portfolio construction. In a sense, current headwinds are acting as a catalyst for strategic reallocation, broadening the investable universe beyond the traditional food groups.

Despite today's economic challenges, commercial real estate continues to offer enduring advantages for institutional portfolios. Historically, CRE has served as an effective inflation hedge, demonstrated low correlation with equities, and delivered consistent cash flows, value preservation, and appreciation through cap rate compression, along with favorable tax implications compared to other investment vehicles. More importantly, many real estate sectors exhibit countercyclical characteristics, which can provide a more recession-resilient income stream that helps portfolios to weather downturns.

Over a longer horizon, we believe that the forces shaping Canadian CRE are more structural than cyclical. Demographics, technology, climate, and policy are likely to redefine both demand drivers and investment opportunities. An aging population will underpin a decade-long sustainable need for senior living and healthcare facilities. Rapid digitization and AI adoption will expand the footprint of data-centric infrastructure. Persistent housing affordability challenges will fuel rental demand, creating opportunities in formats such as purpose-built student housing and self-storage, each positioned to capture spillovers from an undersupplied residential market. Meanwhile, shifts in consumer behaviors, accelerated drug discovery, and evolving supply chain logistics are creating new opportunities for cold storage.

For investors, the long-term story is about more than capturing growth in these alternative sectors or chasing higher returns. It's also about future-proofing portfolios against cyclical downturns and optimizing risk-adjusted returns. Over time, this will reposition alternatives from satellite to core allocations within a resilient, modern, diversified Canadian CRE portfolio.

1 MSCI. Data as of Q2, 2025. **2** Canada Chartbook, Oxford Economics, August 2025. **3** Statistics Canada (StatCan), August 2025. **4** Index of Business Confidence. The Conference Board of Canada, April 2025. **5** "Canada: The Labour Market Slump Deepened in August," Oxford Economics. September 2025. **6** Canada Investment Overview. CBRE, June 2025. **7** NCREIF. Data as of Q2, 2025. **8** "Diversifying Your Portfolio Through Real Estate Investing," Forbes. June 30, 2024. **9** Emerging Trends in Real Estate 2025. PWC, 2025. **10** Preqin Investor Survey. June, 2025.

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