Manulife
Investment Management

Advancing real estate portfolio construction expansion into the alternative asset classes

Demographic shifts, deglobalization, technological innovation and resulting pivots in the way real estate is used is driving capital towards alternative commercial real estate investment. Read how today's capital markets environment is advancing diversification strategies within real estate to potentially drive outperformance for investors.

Key messages

- Attribution analysis shows cap rate compression contributed to 46% to returns during the last decade, with 54% attributed to income and other differentiating factors for the NPI. The current environment will require further diversification of income growth to account for performance.[1]
- ODCE income growth contributed slightly less than half over the same period.[1] Investment managers will require prudent strategies to address this gap in factoring performance in the current environment.
- As capital flows moved into commercial real estate, institutional investor appetite expanded into more sectors across the CRE spectrum, with diversification serving as long-regarded tool to de-risk and generate performance in portfolio construction.
- Over the same time frame CRE witnesses significant cap rate compression and resulting outperformance, the relationship between the built environment and human capital started to transform, elevating the role of Alternative and niche real estate ("Alternatives") in portfolio construction.
- At this point in time, we believe further expanding to address near-term opportunities for yield and long-term income growth and performance.
- Essential to allocators and "private equity style" investors, expanding investments into the real estate alternative sectors could be:

  1. Sector selection guided by key global themes underpinning demand
  2. Operational outperformance via business plan execution and partner and/or platform selection
  3. Access to defendable, micro-market and sector data in driving investment decisions`

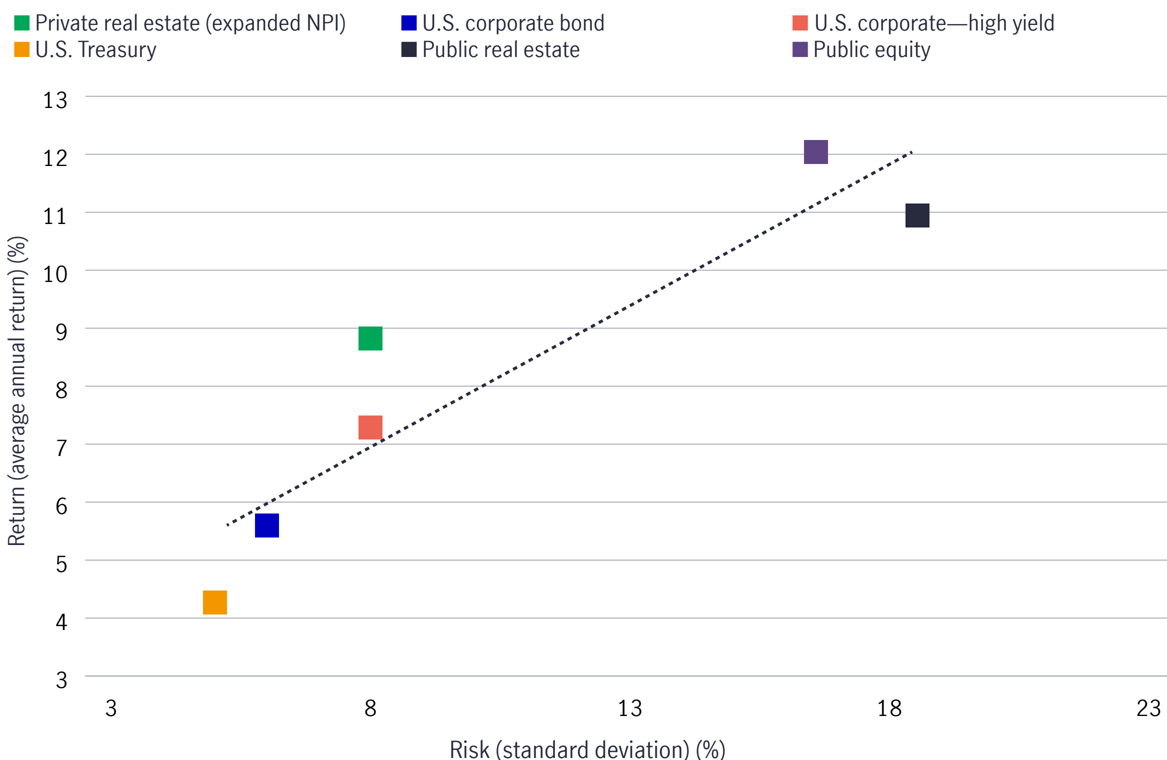
Global institutional investor allocations to the commercial real estate (CRE) sector have increased steadily over the last three decades. Today, on average, institutional investors across the globe have between a 10% and 11% allocation to real estate within their alternative assets allocations.[2] Investors' allocations to CRE grew by 20% from 2012 to 2022, marking a continued shift in investors' preference toward diversifying into real estate.[3] The influx of capital stemming from new allocations, and an extended period of inexpensive debt until late 2022, spurred a particularly robust period of expansion across the CRE landscape. Increased transaction volume, persistent cap rate compression and elevated financing engineering resulted in strong returns. Now, a stricter lending and higher interest-rate environment, compounded by softening demand-side fundamentals across commercial real estate, is giving way to lower valuations, higher yields, and a reset in focus toward income growth.

We continue to make investment decisions in an environment with many unknowns: Macroeconomic uncertainty, risk surrounding property fundamentals, continued valuation fluxes, and constraints on liquidity continue to loom in the sector. Generating alpha in performance in this environment requires diversification across assets that reflect the changing use and preferences within the built environment, driven by thematic divers of demand that support long-term income growth: global housing affordability and supply, supply chain reconfiguration, and transformative technology and innovation. Further investment to expand operational efficiencies and more robust data in formerly opaque sectors with fragmented ownership will lead to more informed investment decisions when building more resilient portfolios for the long term.

Real estate has long been a diversifier

CRE has long been valued as a diversifier in investment portfolios, driving stability by acting as an inflation hedge, with less volatility and fewer countercyclical qualities in select asset types.[4] For many institutional investors, diversification of the overall portfolio is still factored as real estate's most important attraction as an asset class.[5] Private real estate offers equity-like returns at much lower levels of risk compared with conventional assets and public real estate. Private real estate, represented by NCREIF's expanded NPI Index, historically delivered competitive risk-adjusted returns with a higher Sharpe ratio during the past 30 years, providing a greater return per unit of risk compared with conventional assets and public real estate with lower Sharpe ratios.[6] In contrast, although public real estate delivered higher returns, it was accompanied by substantially higher levels of risk.[6] Private real estate's risk, or volatility, is more similar to that of corporate bonds, an attractive attribute that is critical to enhancing the stability of a diversified investment portfolio. Real estate plays a vital role within diversified investment portfolios, just as exposure to different markets and property types plays a vital role within real estate portfolios. Greater diversification opportunities can provide investors with more flexibility and risk mitigation to maintain performance amid the shifting dynamic between cap rate compression and the income growth driving total returns.

Risk return matrix for public and private real estate



Source: NCREIF, Bloomberg, Manulife Investment Management, as of 06/30/2024. All statistics calculated using 12-month ending gross total return series (excluding management fee). Past performance is not indicative of future results. Exposure to an asset class represented by an index may be available through investable instruments based on that index, less management fees. Indexes included: Corporate Bond (Bloomberg U.S. Corporate Total Return Value Unhedged), Public Equity (S&P Total Return Index), Public Real Estate (S&P USA REIT Total Return Index), U.S. Corporate High Yield (Bloomberg U.S. Corporate High Yield Total Return Index Value Unhedged), U.S. Treasury (Bloomberg U.S. Treasury Total Return Unhedged), Private Real Estate (NCREIF NPI Expanded Index).

Changes in use in the built environment

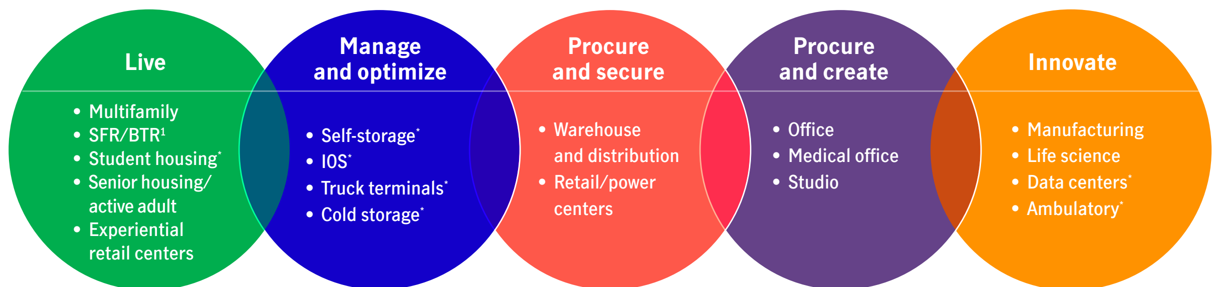
Over the last decade, the relationship between the built environment and human capital has evolved dramatically. The real estate sector is seeing shifts in its response to human behavior and occupier preferences, with some advancements in efficiency and speed. For CRE investors, the desired objectives of value creation, elevated returns, and income growth potential must meet these rapidly changing preferences while managing risk. One pathway to achieving this is portfolio construction that reflects real estate's response to human behavior, which critically, can pivot with further change.

Given the backdrop of globalization, technological innovation, and demographic shifts, investors are looking to realign their CRE portfolios to help achieve the best risk-adjusted returns. The performance of portfolios comprised solely of traditional industrial, multifamily, office, and retail assets has been strained due to softening market fundamentals, primarily among the retail and office sectors, a higher-rate environment, and widening yields. In the ever-evolving landscape of CRE investment management, expanding portfolio allocations to include alternative-focused strategies is becoming an essential tool that can address both near-term opportunities and long-term income growth and performance, while reducing volatility.

Defining alternatives and the evolution of their allocation

Traditional real estate sectors—industrial, multifamily, office, and retail—have long defined the standard allocation split within diversified strategies. Given a lack of data and fragmentation of institutional ownership, alternatives were often allocated to a higher-yield or niche strategy, with lower to minimal exposure to a lower-yielding core, or even value-add strategy. With the growth of institutional investment in alternatives, investors began to flexibly integrate this product within traditional buckets; for instance, including single-family rental into the multifamily allocation or industrial outdoor storage (IOS) into industrial. However, as alternatives exposure grows, the approach continues to vary as do the definitions of "traditional" and "alternative." There's also growing overlap between the purpose and functionality of these spaces, which is a critical consideration for investors looking to optimize portfolio allocation and risk mitigation. While definitions vary among CRE stakeholders and organizations, we define traditional as representing the four major sectors of industrial (warehouse and distribution), multifamily, office, and retail, which are independent of alternative sectors.

Defining alternatives

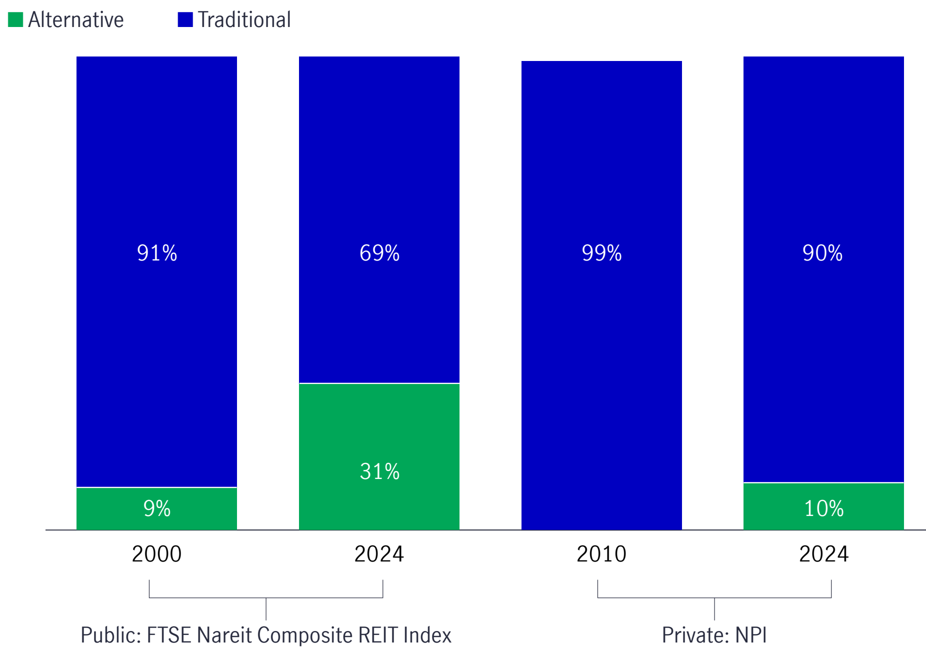


*Alternatives.

For illustrative purposes only.

Institutional investing in CRE has shifted from traditional sectors to alternatives at varying rates between public and private real estate markets. The CRE public market has historically been a leading indicator for private markets' entrance into new sectors. Public markets afford greater liquidity, therefore investors can respond more quickly to changing market conditions while assessing the performance and aggregating the data regarding new sectors. Since 2000, alternatives' share of total allocations increased from less than 10% to more than 30% among the basket of real estate investment trusts that make up the FTSE NAREIT Composite REIT Index. Although shifting at a slower pace, private markets, as represented by the NPI, have increased their allocations to alternatives from minimal in 2010 to approximately 10% in 2024. These allocations are likely to continue increasing as managers reposition funds away from the office sector and toward sectors and subsectors that have the potential to generate higher levels of income growth. Additionally, it's important to note that private markets allocations to alternatives could be larger than the data suggests as nomenclature and subtype categorizations catch up with market realities.

Real estate allocations—public vs. private markets[1,2]



1 NAREIT, data as of 03/31/2024. Alternatives include healthcare (life sciences, medical office), data centers, self-storage, manufactured housing, and single-family rental. **2** NCREIF, data as of 03/31/2024. NPI alternatives include life sciences, medical office, data centers, operating land, manufactured housing, single-family rental, and student housing.

Relative performance of alternatives

Institutional investment into alternatives is increasing the quality and availability of data, but it will likely take several more years to have a comprehensive time series available for analysis across the full spectrum of alternative sectors. Using the limited data available today, alternative sectors demonstrate superior performance relative to traditional sectors over select time periods. Over the last decade, alternative sectors achieved a 10.5% annualized return, outperforming traditional sectors by 320 basis points on average annually.[7] Additionally, alternative sectors accounted for four of the top five performing sectors based on five-year annualized returns as of the second quarter of 2024.[8]

A multifamily sector case study provides valuable insight into how the relative performance of alternatives can potentially provide sources of alpha within a diversified portfolio:

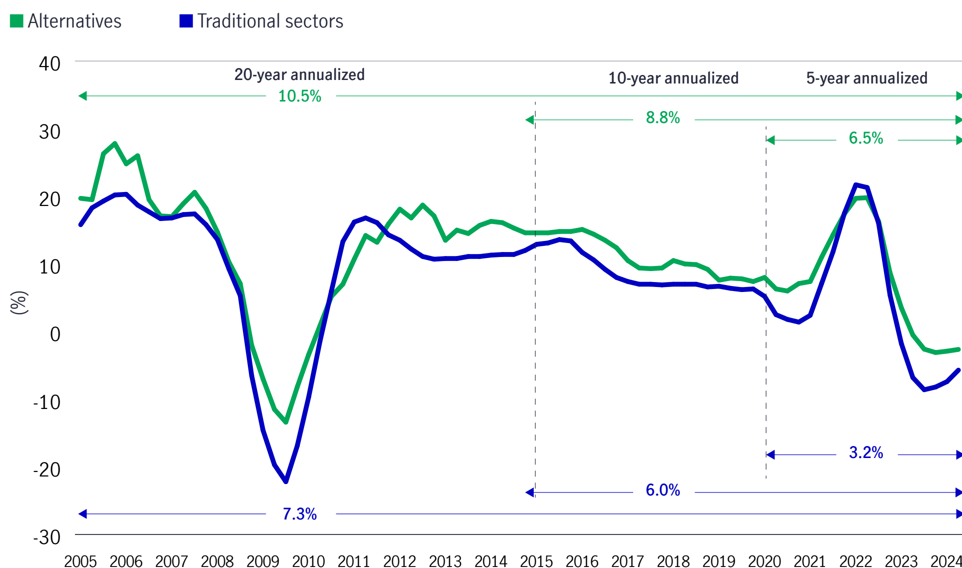
Before 1990	1990–1999	Early 2000s
The multifamily sector comprises less than 5.0% of total NPI allocations.	The NPI multifamily sector delivers an annualized return of 8.8%, while non-multifamily sectors deliver 5.3%.	Institutional investors increase their allocations to approximately 20.0% of total NPI.

Source: NCREIF. Data is as of 06/30/2024. Note: Classic NPI apartment data.

Increasing institutional investment demand to the sector combined with strong demand fundamentals, helped boost apartment returns, despite the economy going through a recession in the early 1990s.

The potential for higher returns due to selection among a larger pool of sectors while also potentially reducing overall portfolio volatility is an attractive opportunity that alternatives can provide within portfolio construction. While varying operational and economic risk factors continue to be at the forefront of all real estate investment decisions, particularly for alternatives, investors are taking prudent steps to mitigate these risks through strategic partnerships and increased access to data.

Alternative vs. traditional performance (NPI – total return)



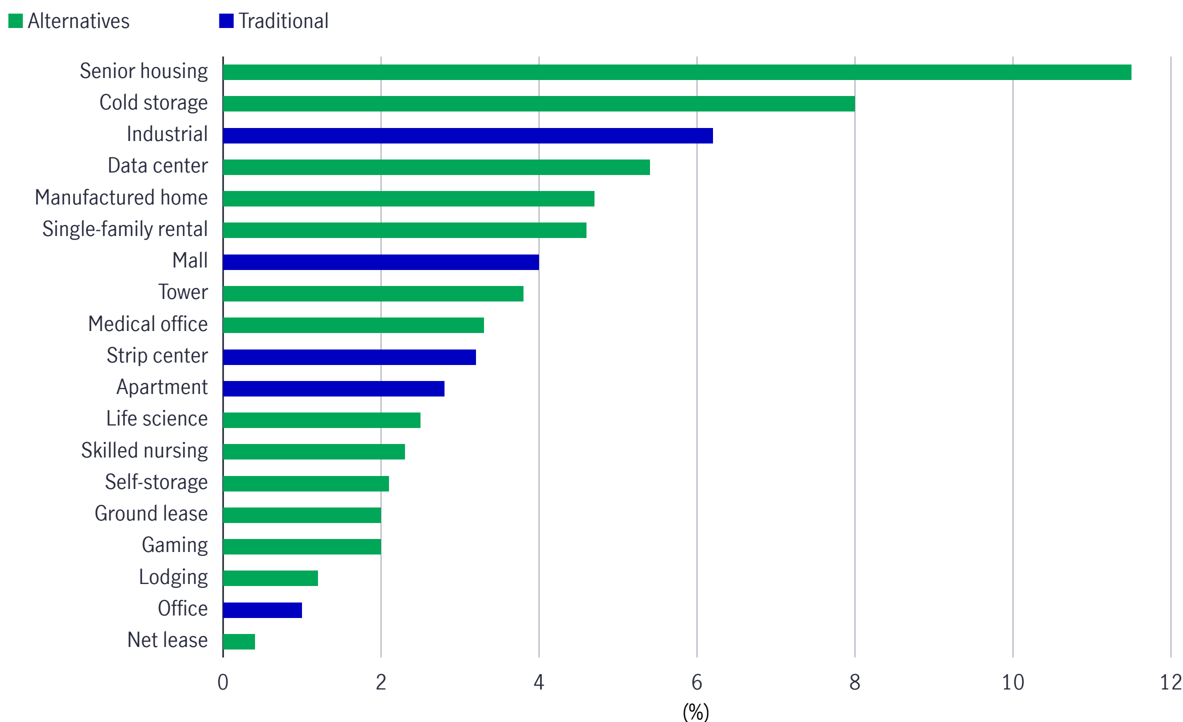
Source: NCREIF. Data is as of 06/30/2024.

Assessing income growth in alternatives

In the expansion period prior to the GFC, record high loan to values, thin lender covenants, and cheap debt laid fertile ground for meaningful cap rate compression. During this period, cap rate compression contributed approximately 60% to total returns for the NPI and 75% for the NPI-ODCE. However, during the period post-GFC through COVID-19, income growth became a more important driver of total returns, contributing around half of total returns for both the NPI and the NPI-ODCE. A tighter regulatory environment and higher debt costs played a significant role. At the same time, investment managers found creative ways to grow income in a challenging market environment. In the absence of cheap debt and abundant liquidity, today's investment managers should prioritize long-term income growth, requiring a thoughtful strategy around sector selection, market selection, and operating performance to enhance returns. Investment managers, and their limited partners, may seek diverse sources of upside for driving income growth. This point is particularly acute when evaluating and attributing fees to management fees and performance.

The elevated focus on income growth in today's environment underscores the importance of expanding portfolio allocations to alternative strategies as a means to drive both near-term and long-term performance. The backdrop of demand has evolved, and so too have the sources that drive income growth. Near-term net operating income (NOI) growth varies widely among real estate subsectors, with a number of alternative sectors expected to grow by more than 4% annually.[9] The rebalance in portfolio allocations to include more alternatives isn't without risk or with guaranteed upside. For instance, alternatives require more specialized operational expertise; and management; and a lack of comprehensive performance data across alternatives can represent a hurdle to financing.

Near-term NOI growth annualized (2024–2028)



Source: Green Street. Data is as of 08/31/2024.

An approach to execution for outsized performance

Critical factors in the investment process that are expanding portfolio construction to include meaningful exposure to alternatives include (1) sector selection that balances global themes and focuses on demand that changes with consumer preferences; (2) operational efficiencies and excellence; and (3) access to and effective leveraging of defendable data.

Thematic drivers of sector selection

In this new era of investing, a diversified portfolio should pivot toward important global themes at the outset of the cycle:

Global housing affordability and supply: The residential/living sector is no longer an emerging trend, but a long-term global challenge underscored by cumulative underbuilding, shrinking supply, declining quality of existing stock, and surging preferences for renting across housing stock. For example, post 2024, the United States still needs to add more than 200,000 units annually to keep up with demand .[10] Alternative real estate sectors that will continue to benefit in the long term from these demographic shifts include single-family rental, build to rent, senior housing, manufactured housing, and active adult.

Global supply chain reconfiguration: Deglobalization and the reallocation of global manufacturing, coupled with rising e-commerce penetration in retail, consumer goods, and food production, will have long-term implications for the demand and use of industrial products. Sectors that will continue to benefit from these structural shifts in the supply chain include cold storage, IOS, urban infill industrial locations, and advanced manufacturing, among others.

Transformative technology and innovation: The anticipated fast paced growth in cloud storage revenues through 2027 and beyond will continue fueling occupier demand for data centers, the expansion of digital infrastructure, and other technology-driven real estate.[11]

The sectors underpinning these global themes all show quantifiable demand in the near and long term to better inform investment decisions. That said, the identification of micromarket demand drivers (e.g., where talent goes to innovate) could be critical factors for sector selection. Further, as these sectors evolve in an environment with many unknowns, supply-side disruptors (known and unknown) should be factored in.

Operational expertise and elevated asset management

Investment performance today hinges on operational expertise, active asset management, and access to data in sectors where operational intel has been opaque or shared in informal channels across the real estate industry.

We believe the ability to execute the business plan is critically important for executing on alternative strategies due to more limited institutional investor exposure and therefore to institutional grade reporting.

Aggregation strategies have been the strategy du jour for operator selection in alternative investment. Expanding institutional investment could or will likely drive data availability and accessibility. Operators with superior technology and asset management could or will likely benefit. Strategic partnerships with the right resources further the ability to structure entry points that offer higher yields and further visibility into business plans, potentially providing additional upside for investment managers. Investors who can harness both opportunities can offer an execution advantage and more intelligence to guide market and asset selection for investment in the alternative space.

In relation to market dynamics and performance impact, as the macro environment continually affects hyperlocal factors (to varying degrees), there could be emphasis on mapping out schematics and understanding the cause and effect of rapidly shifting economic and market tides on business plan execution. The ability to respond to new influences and disruptors proactively and swiftly with agile asset management, through constant reevaluation of performance relative to plan and identification of areas for potential advancement at the asset level, could drive competitive advantage.

Access to data

Finally, as with any approach to portfolio construction, access to defendable, objective, historical, and real-time data is may be key to supporting strategy formation, sector, and market selection. Economic, demographic, and CRE market data is all leveraged for any composition of real estate portfolio and sourced from both third-party providers and proprietary sources. CRE data typically comes with caveats and inconsistencies due to even slight variations in sector and geographical definitions depending on source and varying proprietary approaches to performance measurement.

Alternative CRE data is even more nuanced for several reasons that are predominantly rooted in the evolving nature of the sector. Unlike long-established traditional sectors, where demand drivers and performance indicators are firmly identified and rarely shift, the alternative sector faces hurdles such as the lack of historical tracking and limited—although growing—liquidity and institutional participation in the market. While the lack of historical data can't necessarily be improved and will be a persistent hurdle until data tracking is more mainstream and supported by more third-party providers, increased liquidity and institutional investment will conversely benefit data availability, accessibility, and quality through the refinement of internal and proprietary data. As participation in alternatives increases, the number and types of assets tracked may as well, driving a constant stream of evolving data resources, indicators, and measurements.

Alternative CRE has the potential to drive rapid innovation

The evolution and incorporation of alternative CRE into the institutional landscape has the potential to drive rapid advances in investment strategy. As the space expands, our outlook is for one of continued growth, particularly with consideration to the following:

- **Timing and execution**: Sector expansion may increase market access and elongate investment horizons.
- Asset quality: Asset management is likely to become more efficient as institutional market share increases.
- Dispersion: In a well-diversified portfolio, not every sector will outperform at the same time. Sector diversification will likely or could continue to manage risk and balance volatility.
- Data enhancement: Increased institutional investment may enhance data history and due diligence.

Going forward, given expanding yields and higher interest rates, investors are seeking new sources of upside for total returns to drive income growth. All of these factors will likewise anchor sustainable, long-term income growth and performance in asset-level and portfolio-level returns, lending further credibility to the institutional nature of alternative investments in real estate.

1 NCREIF. Data as of Q2 2024. **2** PREA 2024 Investment Intention Survey. August 2024. **3** Hodes Weill 2023 Investor Intentions Report, November 2023. **4** "Diversifying Your Portfolio Through Real Estate Investing." Forbes, 06/30/2024. **5** PREA 2024 Investment Intention Survey, August 2024. **6** NCREIF, Bloomberg, Manulife Investment Management, as of Q2 2024. All statistics calculated using 12-month ending gross total return series (excluding management fee). Sharpe ratio measures the performance of an investment such as a security or portfolio compared to a risk-free asset, after adjusting for its risk. It is defined as the average of excess return above risk-free return, divided by the standard deviation of the excess returns. U.S. 3-month Treasury bill yield has been used as the risk-free rate. Past performance is not indicative of future results. Exposure to an asset class represented by an index may be available through investable instruments based on that index, less management fees. Indices in analysis included: Corporate bond (Bloomberg U.S. Corporate Total Return Value Unhedged), public equity (S&P Total Return Index), public real estate (S&P USA REIT Total Return Index), U.S. Corporate High Yield (Bloomberg U.S. Corporate High Yield Total Return Index Value Unhedged), U.S. Treasury (Bloomberg US Treasury Total Return Unhedged), private real estate (NCREIF NPI Expanded Index). **7** NPI. NCREIF, data as of Q2 2024. Note: During the 10-year period for which returns were calculated for the NPI, alternative sectors include: life sciences, medical office, student housing, senior housing, and self-storage. Data for data centers, operating land, manufactured housing, and single-family rental was included but did not span the full 10-year history. **8** NPI. NCREIF, data as of Q2 2024. Note: Industrial, comprising flex, manufacturing, and specialized subtypes, is considered one traditional sector for this analysis and represents the best performing sector during the 5-year trailing period. **9** Green Street, data as of Q2 2024. **10** "U.S. Needs 4.3M More Apartments by 2035 to Address Demand, Deficit and Affordability." NMHC. 07/27/2022. CoStar, as of 06/30/2024. **11** Ericsson Mobility Report, June 2024.

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