AEW RESEARCH

Real Estate in a ***(More)*** Fully Funded World

AEW

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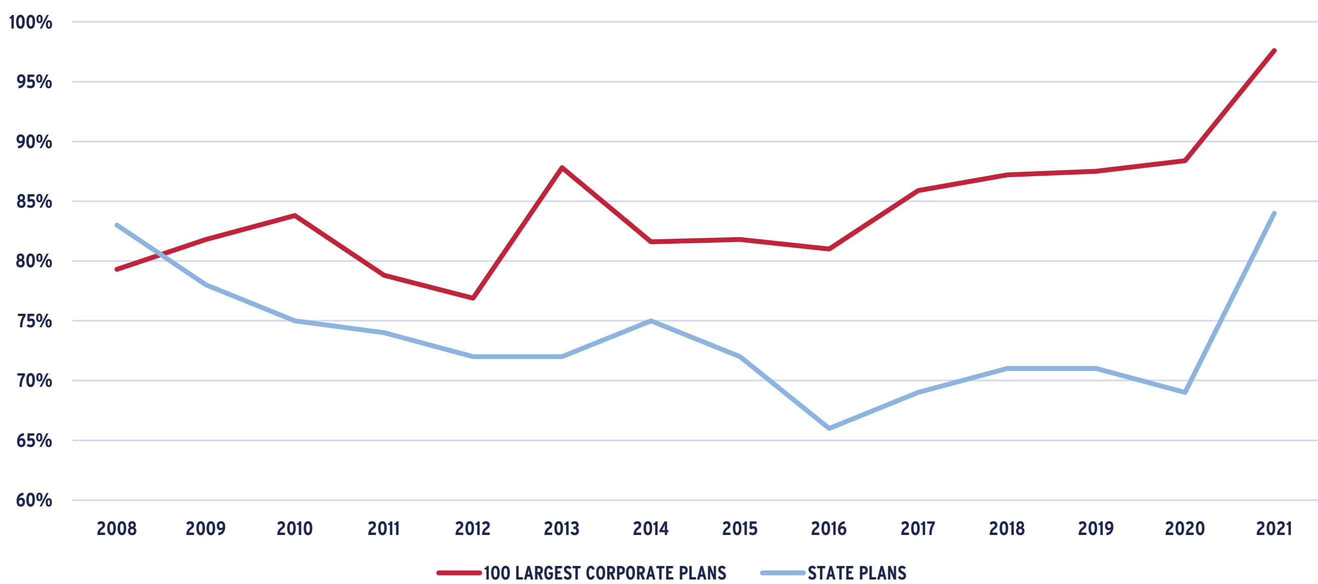
A Place for Everything and Everything in Its Place

Real Estate in a (More) Fully Funded World

The COVID-19 pandemic will be long and largely negatively remembered. Wave after wave of widespread infection, overcrowded hospitals, vast experiments in remote learning, dislocated labor markets, broken supply chains and surging inflation are just a few of the challenges of the past two years. Despite this, something very positive and unexpected happened during the disruption. The nation's pension systems, like many investors, recorded one of their strongest investment performances in decades[1].

FIGURE 1
U.S. PENSION PLAN FUNDED RATIO



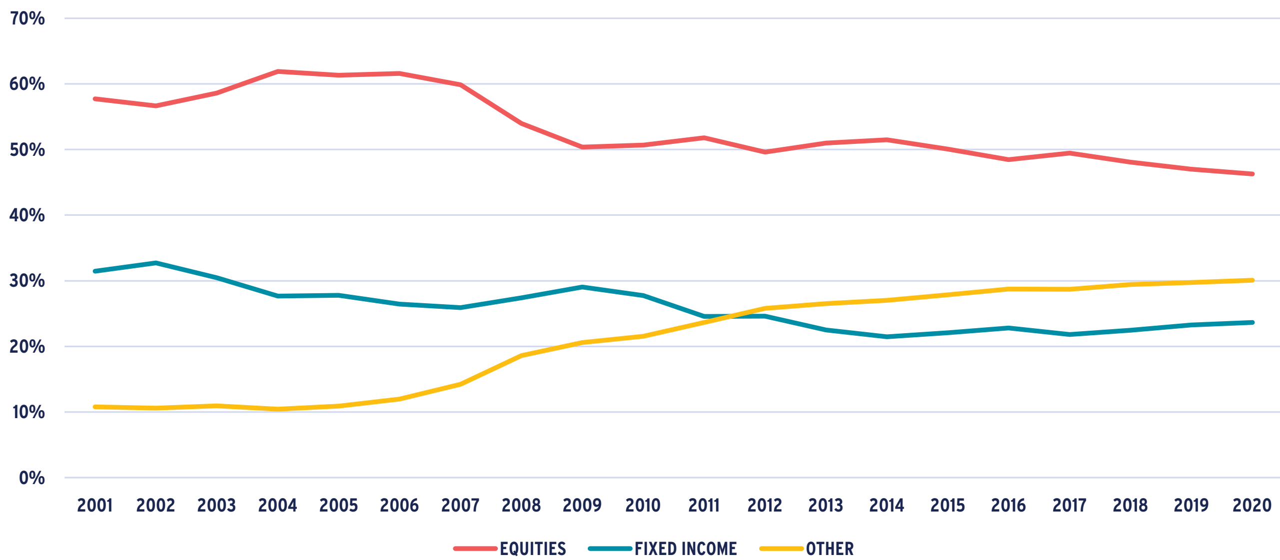
Source: Milliman, Pew Research

As a result, most defined benefit pensions systems became significantly better funded relative to their future liabilities during the pandemic. This is particularly true in the case of corporate pension plans, many of which are fully or partially closed to new participants and the accrual of additional liabilities, but also for public pension plans which, in many cases, are still adding participants and liabilities.

Overall, the average U.S. corporate plan is very close to fully funded with many individual plans now more than fully funded. For public plans, the average funded ratio is now approximately 85%, the highest level since the Great Financial Crisis (GFC) more than ten years ago.

[1] For example, The Pension Fund Return Tracker published by Pensions & Investments show a median public pension plan total return over the past year of 27.4% and a cumulative two-year median total return of 30.6%. https://www.pionline.com/section/returns-tracker

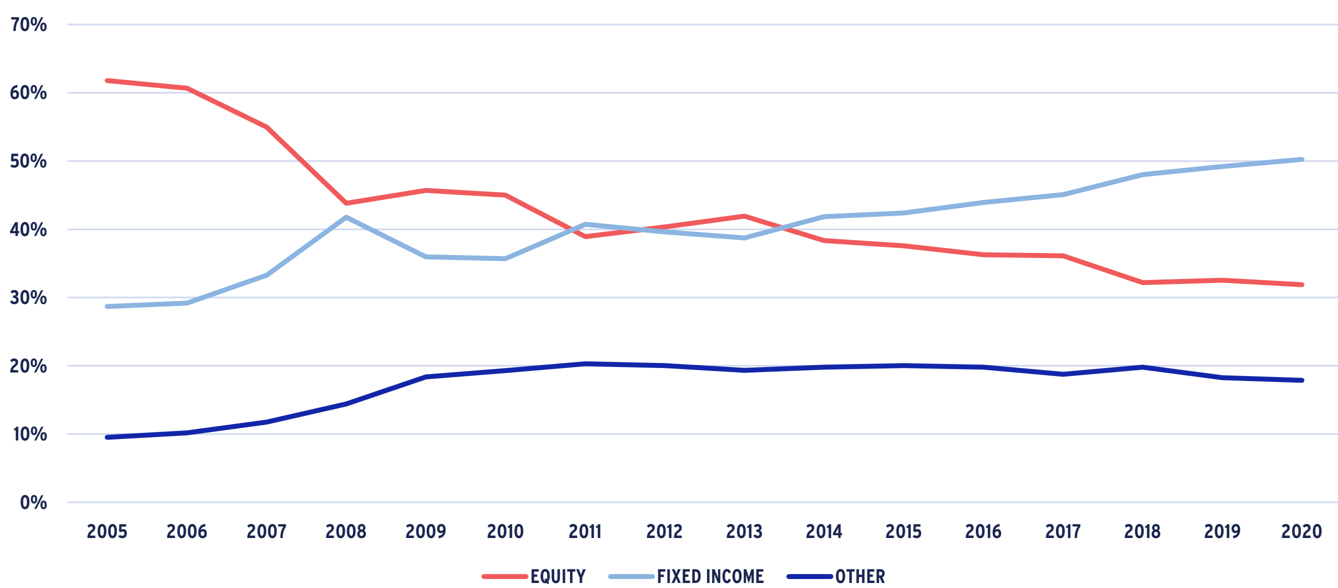
FIGURE 2
AVERAGE PUBLIC PLAN ASSET ALLOCATION



Source: Pew Research

Reflecting the relative differences in funding status, investment horizon and other aspects of risk tolerance, private and public defined benefit pension plans have adjusted their asset allocation in somewhat different ways since the GFC. Both groups have reduced the typical allocation to public equity, with a much larger decline in the more fully funded corporate plans and a smaller reduction in most public plans. At the same time, the average corporate plan allocation to fixed income has increased significantly as more plans employ liability matching strategies. Public plans, in contrast, have generally seen a meaningful decline in fixed income allocations and a significant increase in allocations to various potentially higher return asset classes such as private equity, real estate and infrastructure.

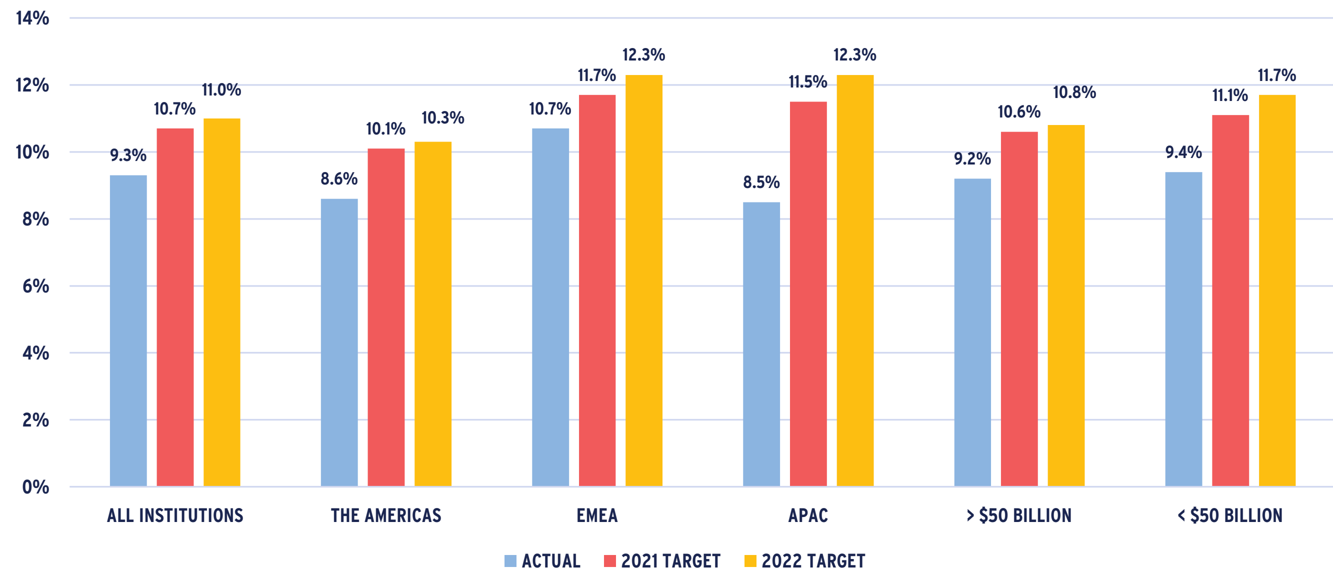
FIGURE 3
AVERAGE CORPORATE PENSION PLAN ASSET ALLOCATION



Source: Milliman

While public and private plan sponsors have differed somewhat in their overall allocation to alternatives generally, both groups are typically currently underfunded relative to their target allocation to real estate, and the target allocation is increasing in most cases importantly, on a growing denominator of total assets. The combined effect of this is, of course, a significant amount of capital seeking productive use in real estate strategies here in the U.S. and globally. While outside of the scope of this discussion, this growing need for productive capital placement in real estate may partially explain the recent increase in investor interest in so-called niche or non-traditional property sectors.

FIGURE 4
INSTITUTIONAL INVESTOR ALLOCATIONS TO REAL ESTATE



Source: Hodes Weill Associates & Cornell Baker Program in Real Estate.

Where Does Real Estate Fit in Today's *(More)* Fully Funded World?

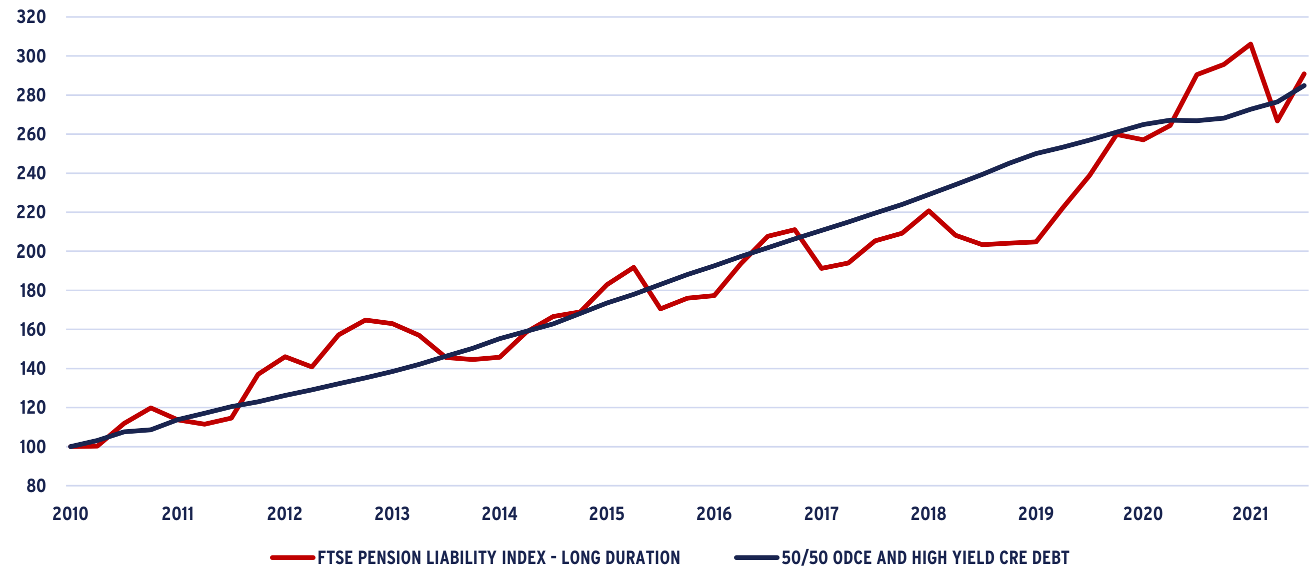
Investors have long added real estate to their portfolio asset allocation mix to pursue one or more investment characteristic traditionally associated with income producing commercial property - higher current yield, inflation hedging and diversification relative to other asset classes. Today, as more plan sponsors find themselves closer to or exceeding fully funded status, many are looking at their real estate allocation in a somewhat different light and asking how real estate might fit in an environment that is less about these traditional asset class attributes, which remain highly desirable, and more about keeping pace, over cycles, with liabilities.

An investor with relatively long duration liabilities might consider a real estate allocation that represents a blend of exposures to core open-ended private equity funds (ODCE funds) and high yield commercial real estate debt[2]. This approach certainly does not guarantee one for one movement with the value of liabilities in any given quarter or year, but does show a strong tendency towards matching liabilities over somewhat longer holding periods[3]. Additionally, the real estate strategy matches the growth in liabilities with significantly less volatility. Figure 5 illustrates both by showing the cumulative growth of liabilities as measured by the FTSE/Russell (formerly Citi) liability index versus a simple 50/50 of core open-ended real estate fund (ODCE) exposure and high yield commercial real estate debt. Changing the ratio of real estate equity and debt simply shifts the slope of the real estate line up (more equity) or down (more high yield debt) over the period shown.

[2]The performance of high yield commercial real estate debt is represented here by the Giliberto-Levy High Yield Real Estate Debt Index (GL-2).

[3]These indices include the FTSE Pension Liability Indexes (short and intermediate) and the FTSE Pension Discount Curve Index. The FTSE Pension Liability Index reflects the discount rate that can be used to value liabilities for GAAP reporting purposes. The index also provides an investment performance benchmark for asset-liability management. By monitoring FTSE Pension Liability Indexes returns over time, investors can gauge changes in the value of pension liabilities.

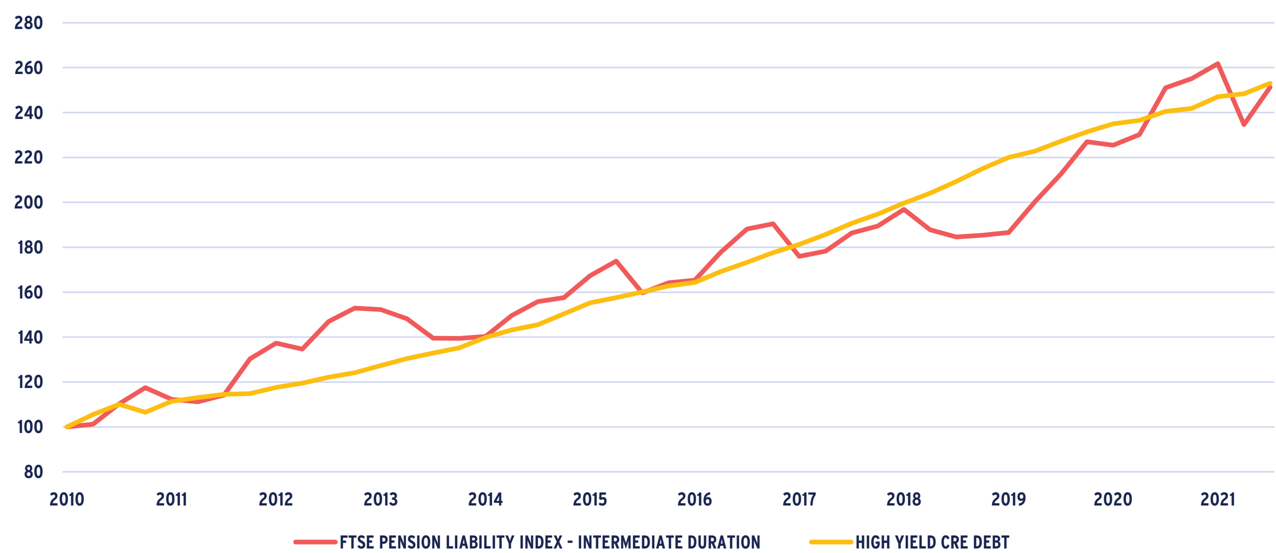
FIGURE 5
CUMULATIVE GROWTH OF FTSE LIABILITY INDEX[4] AND REAL ESTATE DEBT/EQUITY BLEND



Source: FTSE/Russell, Giliberto-Levy, NCREIF

Similarly, for an intermediate duration investor, high yield commercial real estate debt has performed well over the past decade relative to intermediate duration liabilities, again with less volatility. Once more, this does not suggest perfect period- by-period movement of a real estate investment strategy with growth in liabilities, but rather highlights strategies that kept pace with liability growth over cycles.

FIGURE 6
CUMULATIVE GROWTH OF FTSE INTERMEDIATE LIABILITY INDEX[5] AND REAL ESTATE DEBT/EQUITY BLEND

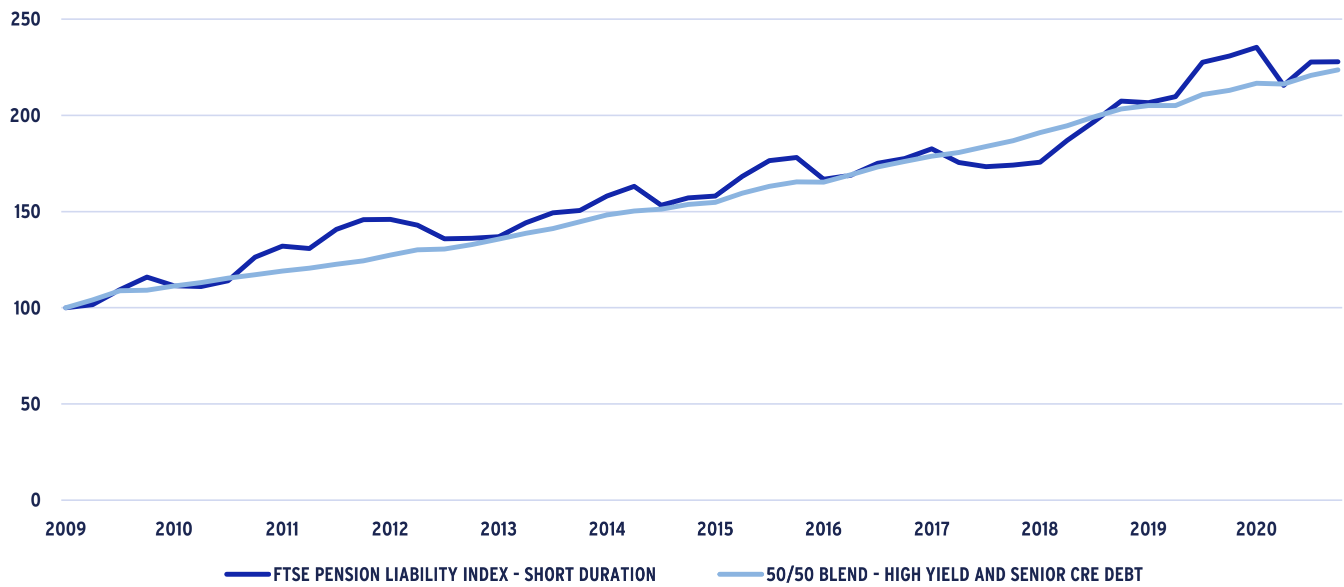


Source: FTSE/Russell, Giliberto-Levy, NCREIF

Finally, for a shorter duration investor, an equal blend of high yield and first mortgage commercial real estate debt would have well matched the shorter duration liability index over the past decade. As with the first example, changing the ratio of high yield and first mortgage real estate debt would have simply shifted the slope of the real estate line up (more high yield debt) or down (more first mortgage debt).[6]

[4]FTSE Liability Index duration of 21.09 as of 2021 Q3.
[5]FTSE Intermediate Liability Index duration of 16.79 as of 2021 Q3.
[6]The performance of first mortgage commercial real estate debt is represented here by the Giliberto-Levy Commercial Mortgage Index (GL1).

FIGURE 7
CUMULATIVE GROWTH OF FTSE SHORT LIABILITY INDEX[7] AND REAL ESTATE DEBT/EQUITY BLEND



Source: FTSE/Russell, Giliberto-Levy, NCREIF

Conclusion

Admittedly, the examples presented here are simplistic. The investment environment facing investors remains complicated and challenging. Very likely, investors will have to contend with negative real (inflation adjusted) sovereign yields for the foreseeable future. Real estate presents numerous characteristics that investors have long thought desirable. Today, as more investors find themselves fully, or at least more fully funded, commercial real estate offers another attribute that may be valuable in this new, and perhaps unexpected, environment; a seemingly strong tendency to keep pace with liabilities over economic and property market cycles, typically with less volatility than the growth in the liabilities themselves.

[7]FTSE Short Liability Index duration of 13.42 as of 2021 Q3.

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