Legacy Wealth and Real Estate

Commercial properties provide critical attributes for sustaining family fortunes.

By Will McIntosh, John Kirk and Mark Fitzgerald

The U.S. commercial real estate market is the third largest asset class in America at more than $17 trillion, trailing only U.S. bonds ($40 trillion) and U.S. equities ($30 trillion). As a result, the asset class has become a staple in institutional portfolios, accounting for roughly 8 percent of total holdings. Family offices typically have an even larger allocation, as direct real estate constitutes 12 percent of the average investment portfolio. Yet, the strategies that drive family office investments often diverge from that of larger institutional stakeholders. For instance, family office portfolios generally overweight single-family residential properties, and when evaluating traditional commercial real estate (e.g., offices, industrial, retail and multifamily) they tend to focus on local assets within a specific region. They are also more apt to pursue higher risk opportunities while concentrating largely on the debt and tax benefits of real estate investments.

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Certainly, there are numerous ways to approach commercial real estate investing, but the previously mentioned tactics ignore the attributes that have propelled real estate into the world's most recognized alternative investment. Even though family offices and large institutional investors may have varying mandates, one of their shared goals is to create and sustain legacy wealth. Therefore, we think it is critical for all investors to grasp how commercial real estate's most compelling characteristics can help accomplish this goal.

RETURNS, RETURNS, RETURNS

Investors can gain commercial real estate exposure through various channels, but for the sake of this article, we will focus solely on the performance attributes of privately held real estate. For more than 30 years, the primary commercial real estate benchmark has delivered consistent performance across economic cycles with an attractive 9.1 percent annual return, outdistancing bonds (7.8 percent) and tracking near equities (11.8 percent). On a risk-adjusted basis, Sharpe ratios for real estate investments compare favorably to equity and fixed-income indices. Even when accounting for the "smoothing" effect associated with appraisal-based performance, commercial real estate still provides attractive risk-adjusted returns relative to stocks and bonds.

HEALTHY CASH FLOW

Commercial real estate has the ability to deliver strong cash flow, which has generally been a key attraction for legacy creation. Historically, income has accounted for up to 80 percent of total returns from commercial real estate. This stable income component is a result of contractual leases that often deliver bond-like cash flow. Even during economic downturns, assuming tenants remain operational, investors can profit from lease-obligated rental income. Such stable cash flow often brings consistency to an investment portfolio, which is particularly valuable during volatile capital market periods.

INFLATION HEDGING

Commercial real estate's ability to serve as a hedge for unexpected inflation is primarily a result of flexible lease structures and, in some cases, frequent lease rollovers. Property owners often peg rental rates to the Consumer Price Index, allowing rents to adjust in accordance with economic conditions.

Historically, office properties have been the strongest protectant against unexpected inflation relative to other major property types. Retail and industrial properties, however, tend to utilize similar mechanisms, which is critical given most leases extend for five to 10 years. Hotels and apartments have shorter-term leases and can hedge inflation quickly; hotels modify rental rates daily while apartment leases typically renew every six to 18 months. Surely, real estate is less effective against inflation in markets where supply levels heavily exceed investor demand, but under normal market conditions, commercial real estate can serve as a solid inflation hedge.

DIVERSIFICATION IS KEY

Commercial real estate provides multiple layers of diversification, and we have found this to be a critical attribute to sustaining wealth. To start, investors can allocate capital in markets with diverse economic drivers (e.g., technology, energy, healthcare and military). In addition to benefitting from diverse geographic locations, investors can differentiate by property type (e.g., retail, office, industrial, hotel and multifamily). The flexibility to invest in a grocery-anchored retail center in San Jose or a multifamily redevelopment in Chicago, for example, helps investors minimize risk associated with local economic downturns, regional weather catastrophes, and varying fundamentals associated with a specific property type.

A second layer of diversification derives from the various investment strategies available within the commercial real estate universe. While low-risk investments are probably more appropriate for long-term legacy creation, value-add and opportunistic investments are higher on the risk/return spectrum, but also allow investors to select the right combination for their investment goals.

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A third layer of diversification comes from properties with multiple tenants. This is not always the case, but when applicable, investors can diversify cash flow at the property level by leasing to tenants from dissimilar industries. If, for instance, a tenant defaults because of a technology sector slump, the impact to the building's cash flow will be less severe if the property has multiple tenants from various industries.

CONCLUSION

In the end, commercial real estate investing can be a worthwhile opportunity for the right situation. Certainly, each family office and institutional investor operates within unique parameters, which may limit participation in some strategies. When possible, however, investors should consider investing in commercial real estate because it can play a key role in a multi-asset portfolio's ability to create and sustain legacy wealth. ■

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