ABR Dynamic Funds' Portfolio Construction Series: Part 8

Fooled by the Wrapper III: Real estate has behaved a lot like the equity market

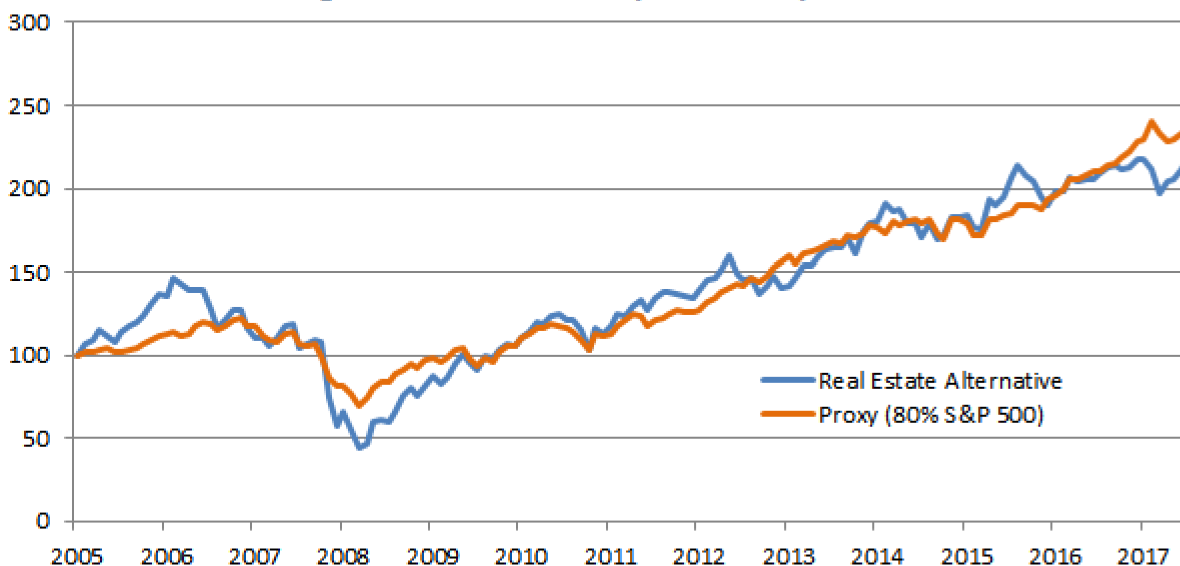
Real estate investments have behaved very much like the equity market. Let's consider why this may make sense. Companies, whether they are publicly traded corporations or private real estate investment companies, have property: intellectual property, employee time and effort, factories, office buildings, farmland, etc. Those companies generate cash flows from their property. The net present values of all of the expected future cash flows of those companies have been affected similarly by economic outlooks and interest rates. Economic outlooks affect how large those cash flows may be, and interest rates affect how the cash flows are discounted to present value. That has been true whether the cash flows were generated by licensing intellectual property or by collecting rent on an office building. **In other words, changes in the fundamental prices of stocks and real estate investments share significant drivers.**

It is true that sometimes the net asset values of stocks and real estate have seemed to take very different paths. **Real estate investments may have appeared more stable, not subject to market fluctuations. However, that's largely because many real estate holdings haven't been marked to market daily. In other words, that perceived stability was mostly an illusion of stale pricing.** We will have more to say about this illusion in future installments on private equity and direct lending, but, when it comes to real estate, suffice it to say it's rather like thinking "the price of my house had zero volatility over the past 2 years because I never had it appraised." When it came time to buy or sell, the fundamental price was affected by economic outlooks and interest rates.

This line of reasoning indicates that real estate has not been "alternative" in anything but name, which is part of what we have been calling the "wrapper" in this series on portfolio construction. That conclusion is supported by the following graph, which shows a real estate strategy that is marked to market every day, along with a proxy which is just 80% exposure to the S&P 500. **The behaviors were similar, especially when it mattered most, in a crisis.**

- **Real Estate Strategy vs. Proxy**
  - Proxy Allocations:
    - 80% equity behavior (SPY – S&P 500 ETF)
    - 20% idle capital

Figure 23: Results from Jan 2006 to Jun 2018



Source: ABR white paper (date from Bloomberg)

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We will close this installment by noting a clue, drawn from the above discussion, to where to look for true diversification. However, before getting to that, the following excerpt from ABR's white paper on portfolio construction discusses the shortcomings of so-called alternatives that can easily be mimicked with core exposures, especially with reduced amounts of core exposures. It will be familiar to readers who have been following this series on portfolio construction.

Excerpt from ABR's white paper on portfolio construction

Perhaps most importantly, the proxies for typical forms of many of these "alternative" strategies use *reduced amounts* of core exposure to achieve results similar to the "alternative" strategies. This feature, while touted by some managers as a benefit in the form of volatility reduction, is actually quite detrimental to investors.

For example, consider an "alternative" that always moved half as much as equity behavior (0.50 beta), in the same direction as equity behavior (1.00 correlation). This hypothetical alternative:

- Tied up twice as much capital as direct exposure to the equity behavior it mimicked.
    - That capital should have been hard at work elsewhere. Diluting exposure to equity, or any other, behavior only serves to tie up more capital and require more leverage to reach the target exposure level.

- Provided no diversification value whatsoever to the equity behavior it mimicked.
    - It lost every time equity behavior lost, totally eliminating the only free lunch in investing.

- Generated a diluted return compared to the equity behavior it mimicked.
    - Diluted equity returns may have been a luxury investors could afford in a raging bull market, but what if future S&P 500 returns are much lower? How will investors feel about diluting already low returns?

We wish to note that this example should not be taken to mean that all forms of real estate strategies are bad. The ones that carry the features just discussed may be, but that is not intended as a criticism of the ones that do not.

Closing thought

This installment provides a clue to where to search for truly diversifying (alternative) investments. Look for investments that are affected differently than stocks by changes in economic outlooks and interest rates. We will have more on this search as we begin to construct sample portfolios toward the end of this series on portfolio construction.

Next Week's Preview: The Active vs. Passive debate is a red herring.

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