Nareit® Research Note

May 2024

Market Efficiency and Net Value Added by Listed and Unlisted U.S. Institutional Real Estate Portfolios: CEM Benchmarking

New research by CEM Benchmarking shows that REIT active management has consistently added net value in commercial real estate (CRE) portfolios.

Before fees, or on a gross basis, both REIT and private real estate portfolios add value, or generate alpha, versus their benchmark. Yet that picture changes after fees, or on a net basis. In private real estate, institutional investors, on average, underperform their benchmarks because the fees associated with investing in private real estate ultimately exceed any of the alpha generated.

By contrast, for the average listed equity REIT portfolio, investors gain 32 basis points (bps) after fees.

Methodology

The study uses a 24-year (1998-2021) dataset representing more than 350 U.S. institutional investors, primarily defined benefit (DB) pension funds. Portfolio performance is measured against the investor's chosen benchmark. The most used benchmarks for REITs are FTSE Nareit and FTSE EPRA Nareit indexes, accounting for over 60% of portfolios. For private real estate, NCREIF based indices (ODCE and NPI) are the most popular benchmarks accounting for over 75% of portfolios.

Key Highlights

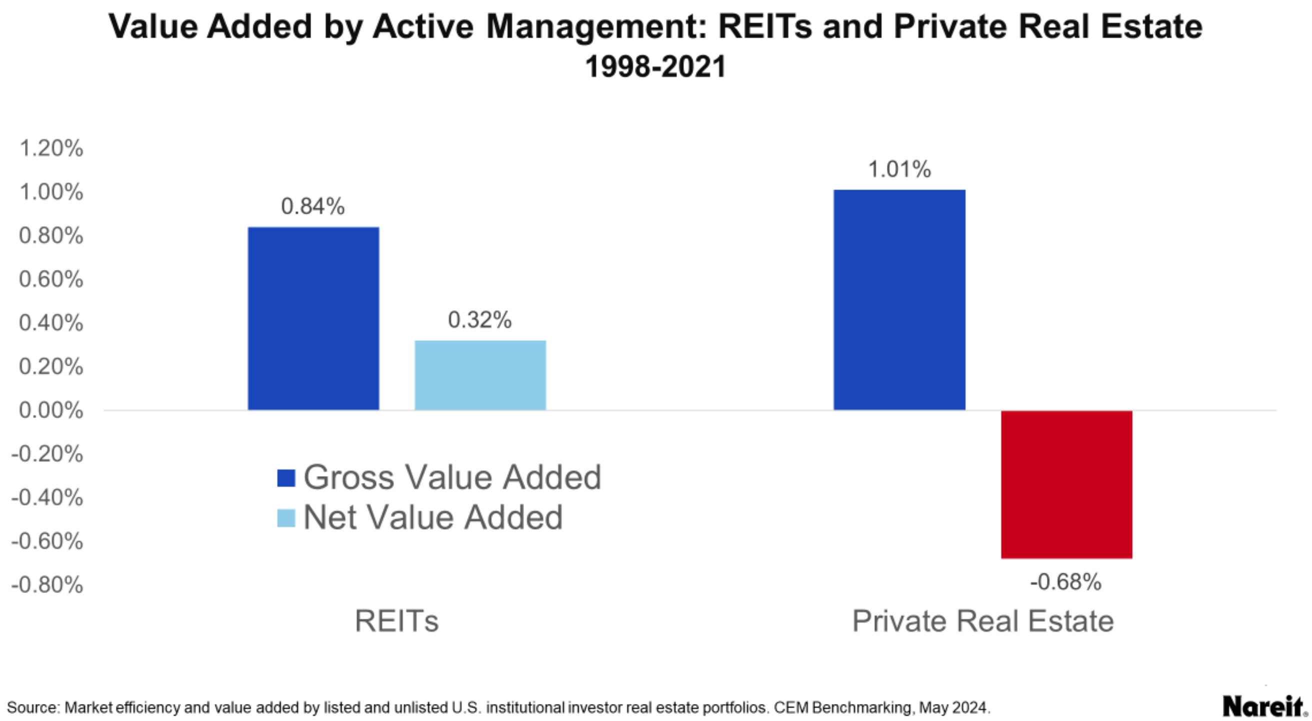
- Before fees, actively managed REIT portfolios generated an annual average value-added return of 0.84% per year versus an annualized benchmark return of 9.6%; private real estate portfolios generated an annual average value added return of 1.01% per year versus an annualized benchmark return of 9.1%.
- After fees, actively managed REIT portfolios generated a value-added return of 0.32%; private real estate portfolios generated a negative net value added return of -0.68%.
- REITs outperform private real estate before and after fees across the distribution of value added and average annual returns. For example, a REIT portfolio in the 75th and 90th percentile of REIT net returns and net value added outperforms a private real estate portfolio at the same percentile of private real estate returns.
- REIT outperformance across the returns distribution suggests that private real estate investors who focus their strategies on top-quartile real estate managers could enhance returns by selecting top-quartile active REIT managers.

Main Idea

After fees, actively managed REIT portfolios generated a value-added return of 0.32%; private real estate portfolios generated a negative net value added return of -0.68%.

REIT Active Management Adds Net Value to CRE Portfolios

Over time, REITs and private real estate provide access to real estate returns. CEM Benchmarking's 2023 study shows that after accounting for reporting lags, the correlation between REITs and private real estate is 0.91. However, REITs have consistently outperformed private real estate in net and gross returns.



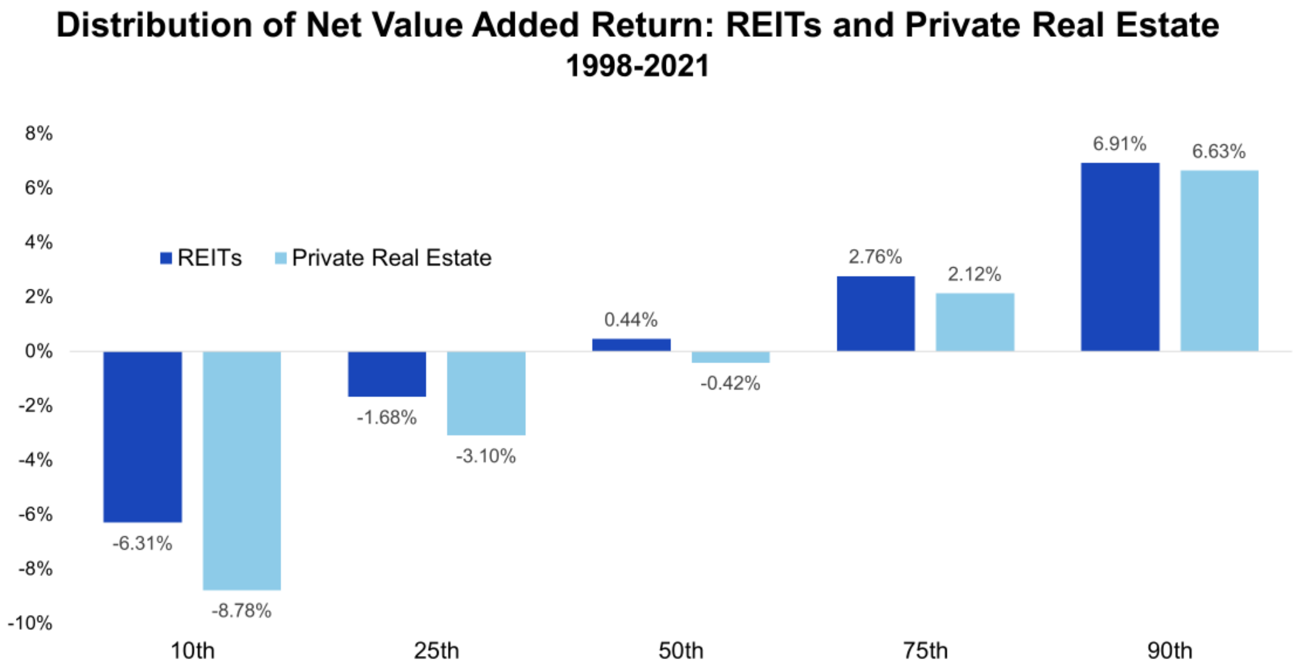
As the chart above shows, actively managed REIT portfolios have consistently outperformed private real estate in net value added or the return in excess of the relevant benchmark.

- Before fees, actively managed REIT portfolios generated an annual average gross value added return of 0.84% per year versus an annualized benchmark return of 9.6%. After fees, on a net basis actively managed REIT portfolios generated a net value-added return of 0.32%.

- Before fees, private real estate portfolios generated an annual average gross value added return of 1.01% per year versus an annualized benchmark return of 9.1%. After fees, on a net basis, private real estate portfolios generated a negative net value added return of -0.68%.

REITs Add Value Across Returns Distribution

The unique nature of the CEM data allows the report to explore the distribution of net value-added.



Source: Market efficiency and value added by listed and unlisted U.S. institutional investor real estate portfolios. CEM Benchmarking, May 2024.

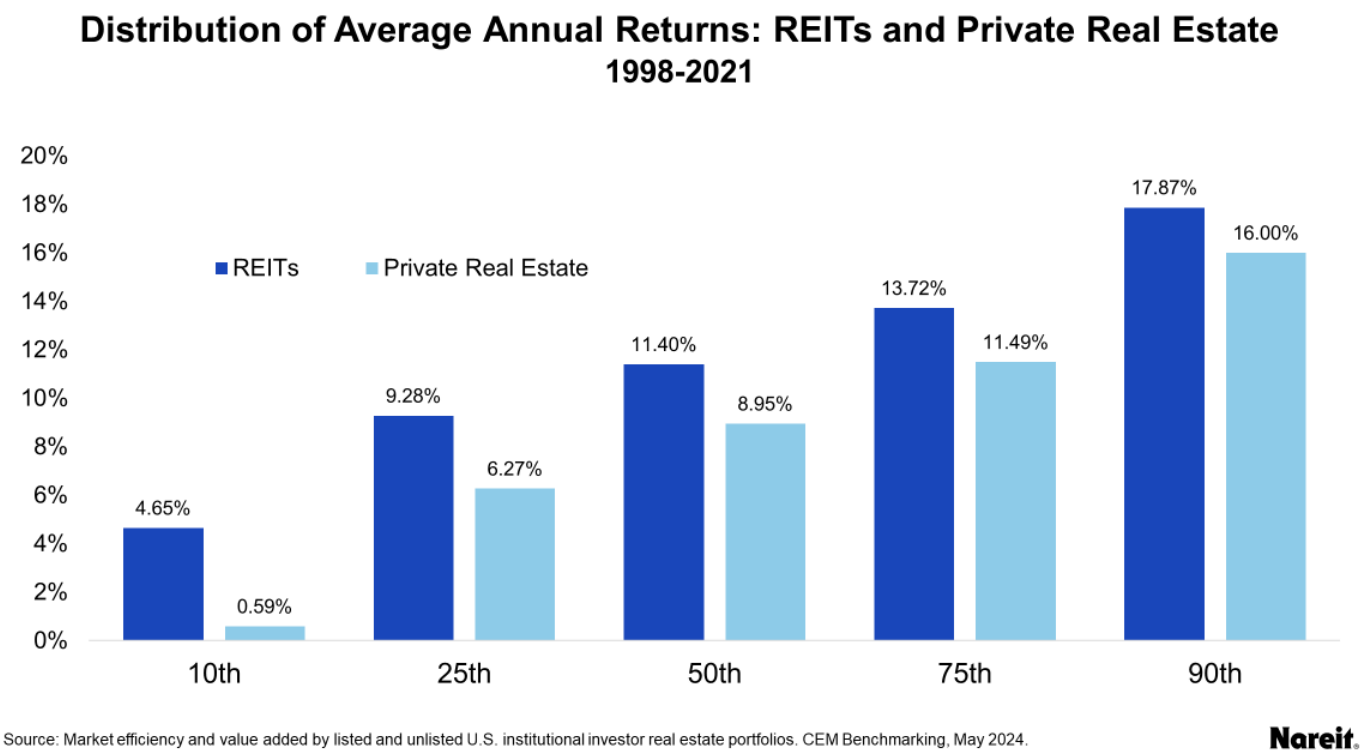
As the chart above shows, after fees, REITs outperform on a value-added basis between the 10th and 90th percentiles of the value-added distribution. In the extreme positive tail of the distribution, private real estate outperforms REITs; in the extreme negative tail of the distribution, private real estate massively underperforms REITs.

REIT outperformance across the distribution suggests that private real estate investors who focus their strategies on top-quartile real estate managers could enhance returns by selecting top-quartile active REIT managers.

Notably, private returns have a wider distribution than REITs, which reflects the broader dispersion of returns, as private strategies tend to encompass portfolios with a smaller number of properties that are less diverse. Whereas REIT strategies encompass portfolios with a much larger number of properties that are generally more diverse because they span a broader set of property sectors. This is reflected in the standard deviation of net value added; the standard deviation for private real estate strategies is 9.6% versus 8.3% for REIT strategies.

REITs Outperform Across the Distribution

The study also examines the distribution of gross and net returns in a “typical” year.



As the chart above shows, after fees, REITs outperform between the 10th and 90th percentiles of the value-added distribution. In other words, at almost any percentile of REIT performance, REITs generate more alpha and higher net returns than at almost any percentile of private real estate performance. Again, this REIT outperformance suggests that private real estate investors who focus their strategies on top-quartile real estate managers could enhance returns by selecting top-quartile active REIT managers.