The Danger in Private Real Estate Investments

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A question I'm often asked involves the merits of investing in private real estate as an alternative to publicly available REITs (the latter vehicle is our recommendation). To answer that question, I will turn to the historical evidence, which we have courtesy of Cambridge Associates.

Cambridge Associates' private investment database is an extensive collection of institutional-quality private fund performance. It contains historical performance records for more than 2,000 fund managers and their more than 7,300 funds. In addition, it captures the gross performance information of more than 79,000 investments underlying venture capital, growth equity, buyout, subordinated capital and private equity energy funds.

Cambridge Associates' database allows us to compare the performance of these institutional private real estate funds with the performance of publicly available REITs. For the 25-year period ending 2017, private funds in the database returned 7.6%, while the FTSE NAREIT REIT All Equity Index returned 10.9%. For the privilege of investing with the greatest institutional managers, many of whom are not available to the general public, and in return for sacrificing the daily liquidity available with public REITs, the private, illiquid institutional investments underperformed by 3.3 percentage points a year for 25 years.

As bad as that sounds, the reality was actually far worse. The reason is that the private real estate investments used much higher amounts of leverage.

Private real estate study

In a 2017 article, "Comparing Listed REITs with Private Equity Real Estate: What the Cambridge Associates Data Have to Say," Brad Case, senior vice president at NAREIT, showed that while private real estate investments were producing lower returns, they also were taking on much greater risk in the form of higher leverage.

Quoting Case: "The now-defunct NCREIF/Townsend Fund Indices reported that average leverage for the funds in its sample during the available period 2007Q4-2013Q3 was usually between 51% and 56% for value-add funds and between 53% and 64% for opportunistic funds – but over the same period it was usually between only 36% and 47% for equity REITs. [Cambridge Associates] doesn't report average leverage for the funds in their benchmark, but they do report that 'in terms of limited partners' total paid-in capital, the [Cambridge Associates] Real Estate benchmark is 71% Opportunistic and 29% Value-Added.'"

(My reading of the Cambridge Associates report is that those final two figures are actually 70% opportunistic and 30% value-added, but the difference is small.)

Thus, based on the information in the database, we can conclude not only that private real estate investments earned much lower returns, but that they did so while taking on much greater risk. Case offered the following analysis of the incremental risk taken by the private real estate investors. He writes:

- 41% leverage – the median value for the equity REIT industry during the 2007Q4-2013Q3 period – increases volatility by 69%. (As of 2017Q2 REIT leverage had fallen to an average of just 33%, which implies only a 50% increase in volatility.)
- 54% leverage – the median reported by Townsend/NCREIF for value-added funds over the same period – increases volatility by 117%.
- 60% leverage – the median for opportunistic funds – increases volatility by 150%.

While institutional investors obviously believe they are able to identify managers who will deliver outperformance, the evidence is clear that they have not done so. Like many other investors, it appears they are guilty of overconfidence.

Case added: "There have been more than a dozen academic studies comparing the performance of listed and private equity real estate using different data sources, time periods, and methodologies, and all of them – every single one – has reached the same conclusion as Cambridge Associates: they all found better average performance on the REIT side, even after controlling for differences in the use of leverage, the mix of property types, and the geographic distribution of properties."

Case's analysis also demonstrated that even if institutional investors could identify the best managers ahead of time (and there's no evidence for that), the Cambridge Associates data shows public REITs frequently have outperformed even the top quartile of private equity real estate funds.

Conclusions

Not only do publicly available REITs have the advantage of providing daily liquidity, today investors can access the asset class at exceptionally low costs. For example, the Schwab U.S. REIT ETF (SCHH) has an expense ratio of just 7 basis points.

The only question that remains is what, exactly, private real estate has to offer (other than the privilege of enabling institutional investors to be a "member of club"). And as Groucho Marx famously said, "I refuse to join any club that would have me as a member."

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