Real Estate— A Strategy Imperative

The Case for Direct Real Estate Investment

At Trinity Real Estate (TRE), we are unabashedly passionate about investing in direct commercial real estate. Commercial real estate assets provide the potential for higher income, value creation, stable returns, inflation hedge, tax benefits and added diversification to investment portfolios. Direct ownership of real estate assets offers several unique attributes unavailable with other investment vehicles, whether private or public.

However, moving from a conceptual "yes" on real estate investing to a properly risk-adjusted real estate portfolio requires a good understanding of the various investment options, coupled with a carefully identified risk tolerance and enumeration of investment return requirements. For family offices the *type* of ownership is also a decision factor. This paper provides a foundation for the rationale of real estate investment, together with a description of strategy formulation and property/class characteristics. Furthermore, we identify several benefits available only by owning real estate assets directly, as well as certain competitive advantages a family office can utilize.

Why Real Estate?

Real estate offers several unique features and elements that investors find attractive. Pension funds, institutional investors, sovereign wealth funds, and family offices all invest in real estate—and it often makes up a material component of their investment portfolio.

In the modern era, real estate has become a significant asset class, with broad and diverse ownership. Globally, commercial/investment real estate is valued at approximately $11.9 trillion, comprising approximately 10.9% of the investment universe.[1] Of this total, approximately $6.1 trillion is equity (56%) with the balance (44%) as debt instruments. We see a higher debt ratio when looking at the U.S., albeit the available data excludes smaller portfolios and private ownership yet includes private and public debt. Given these constraints, the U.S. national market for real estate is estimated at approximately $6.2 trillion--$1.8 trillion identified as public or private equity.[2]

The growth and scale of commercial investment real estate is largely attributable to the multiple benefits it brings to a balanced portfolio. These include complementary portfolio returns, a ratable income stream, diversification, tax (timing) benefits and an inflation

---

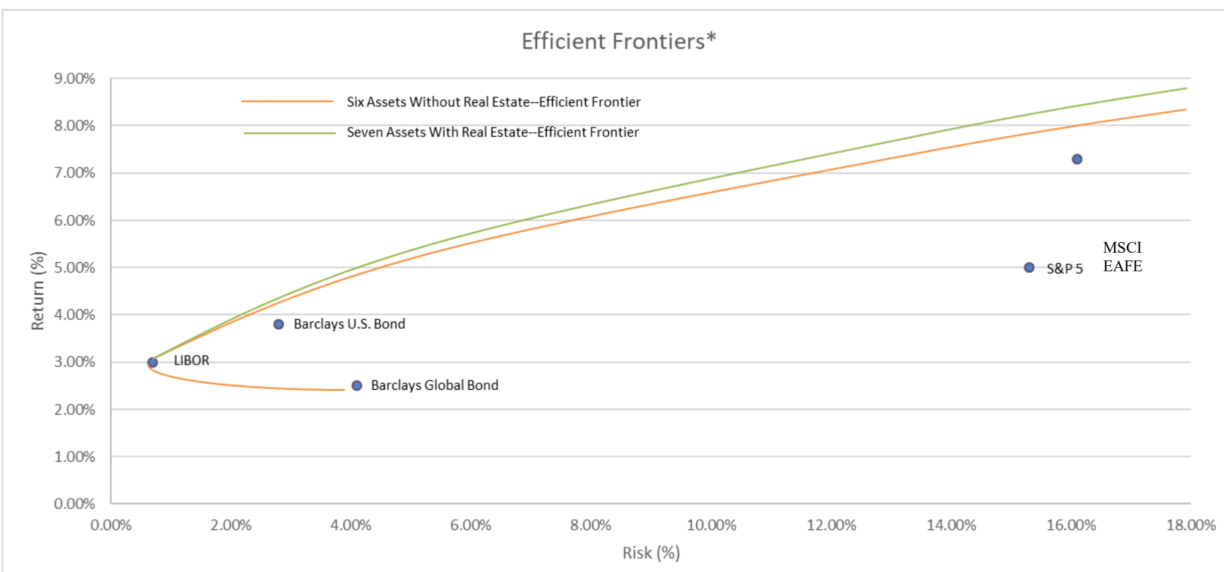
[1] AON Hewitt/Sudhakar Attaluri "Global Invested Capital Market". (May, December 2015).
[2] Greg MacKinnon, Pension Real Estate Association (PREA), "Why Real Estate" Q32018

hedge. Historically, real estate returns have balanced between equities and bonds, providing a strong complement to an overall portfolio return.

	S&P 500	**NCREIF Property Index**	**Barclays US Bond Index**
*Avg Annual Return**	13.7%	9.5%	7.6%
Volatility	16.3%	7.5%	6.8%
*Sharpe Ratio***	0.5	0.5	0.33

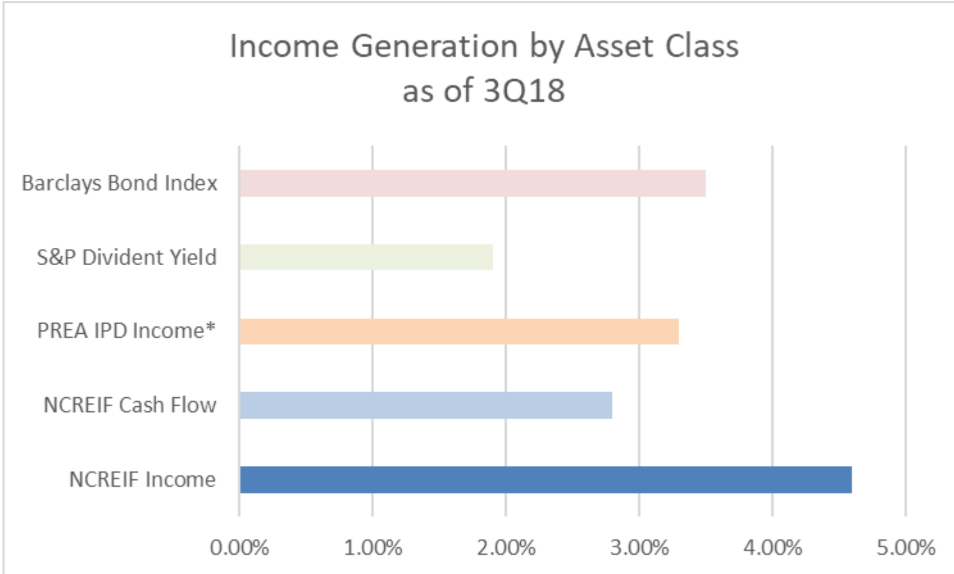
* *1978-2017*
** *Avg return above one-year treasury yield, divided by volatility. This measures risk- adjusted performance.*

This complementary return element creates an important contribution to portfolio performance. When studied over time, balanced investment portfolios that include real estate perform better. The corollary is also true—including real estate allows for attaining a performance benchmark (holding all else constant) with less risk. Often referred to as an Efficient Frontier Analysis (part of modern portfolio theory), it incorporates the respective returns and risks for each of the investment assets held in a portfolio. There have been multiple studies reviewing real estate in this regard, and the consensus indicates the addition of real estate improves performance and/or reduces risk. The following (example) chart highlights the impact of including real estate within a portfolio as studied by Lazard Asset Management.



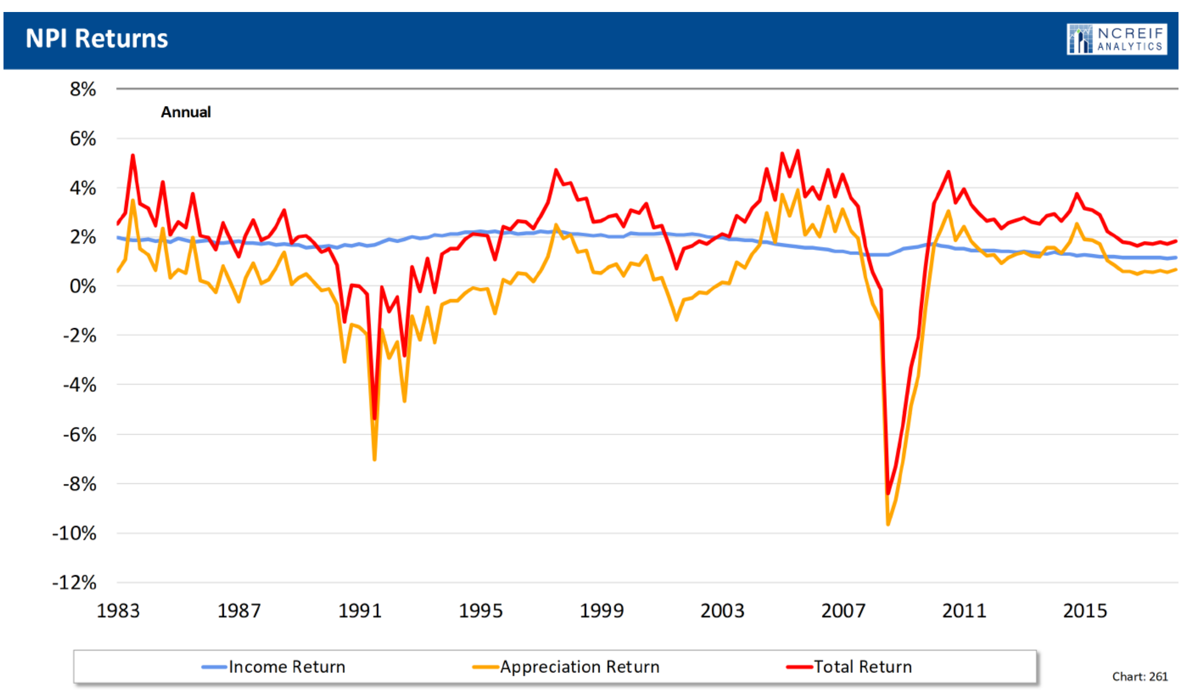
**Lazard Asset Management, "The Impact of Real Estate Allocation in a Diversified Portfolio", 2014.*

Improved returns are only part of the story. Another benefit of real estate is its income (cash flow) component. While the following table is a representation of recent returns (and reflective of our current low interest rate environment), it demonstrates the relative benefit of income and cash flow from real estate holdings.



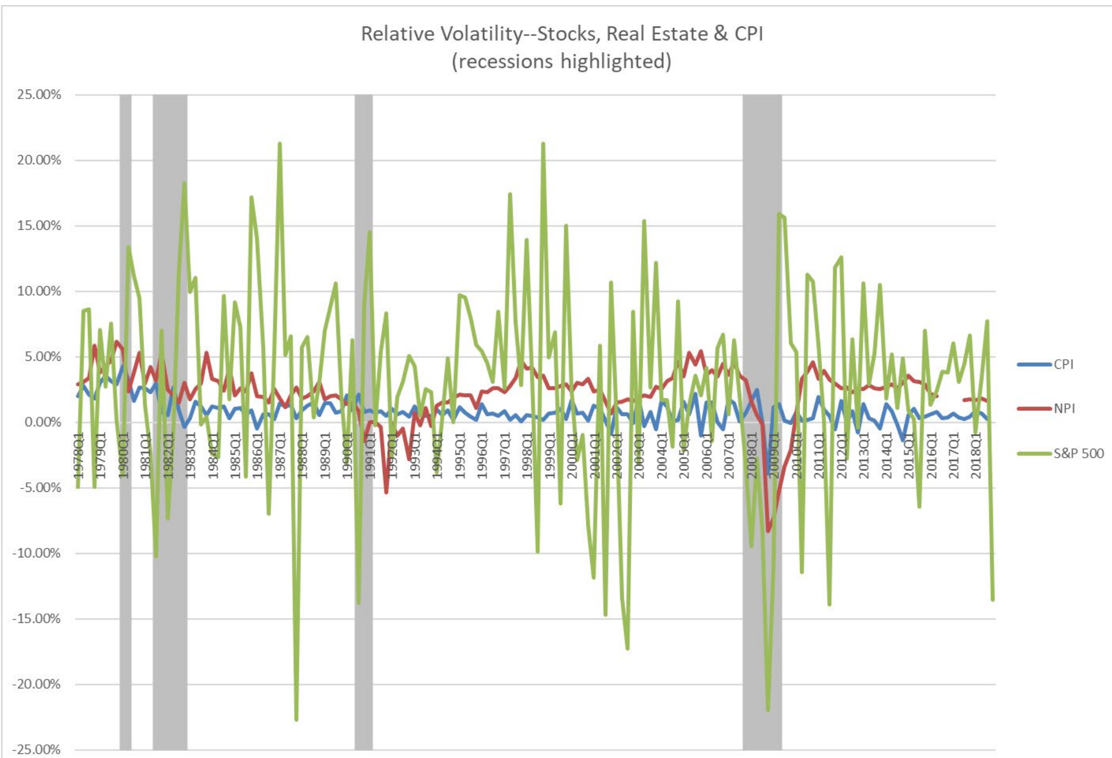
Source: PREA, "Why Real Estate", Q3 2018 Presentation
**IPD via MSCI (Morgan Stanley Capital International) provides global real estate indexing and benchmarking data and analytics*

The income component helps reduce some of the volatility that may otherwise be present in a portfolio more heavily weighted to equities. For example, looking back over three decades, the income component of total real estate returns has remained relatively steady. The following chart indicates the income, appreciation, and total returns for NCREIF's Property Index (NPI) for the period 1983-2017.[3] The NPI represents private, commercial real estate assets primarily acquired on behalf of tax-exempt institutional investors and held in a fiduciary capacity. It is worth noting the NPI data is adjusted to an unleveraged basis, and generally includes "core" or low risk assets.



[3] NCREIF Indices Review, August 14, 2018, NCREIF Analytics, Kevin Scherer.

At the same time, volatility of total real estate returns is far less pronounced than equities. Looking at quarterly returns for the S&P 500 vs. the NCREIF National Property Index provides a vivid demonstration of the reduced volatility with real estate assets. It should be noted using the NPI data necessarily skews the reported real estate returns somewhat as the assets in the reporting database are generally well-located, fully leased, stable, institutional-grade properties with little or no debt. Including real estate assets in secondary markets or that were more opportunistic would likely impute a somewhat greater volatility. Nonetheless, the combination of relatively stable income (from longer term tenant leases) coupled with modest value changes leads to stable overall return and trend. The change in CPI is also identified within this chart to show the respective correlation with inflation levels.



Source: NCREIF, Bloomberg, U.S. Bureau of Labor Statistics

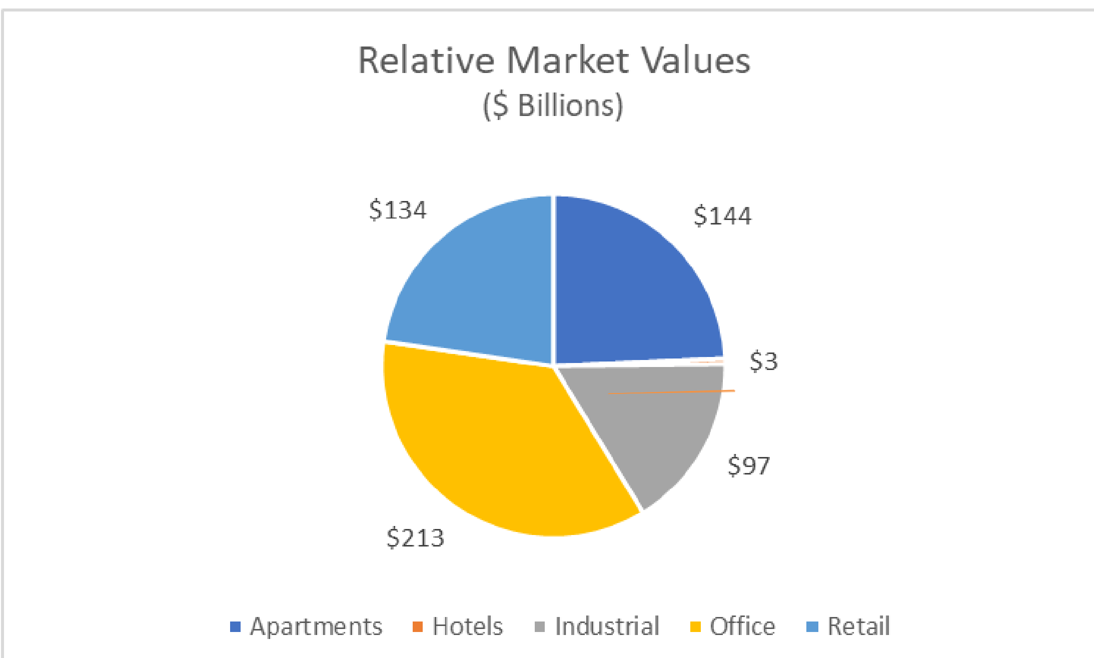
In summary, TRE believes the case for commercial real estate ownership within a broader portfolio is compelling.

Real Estate Risk and Return Spectrum

There is a myriad of ways which you can invest in real estate across a multi-dimensional spectrum of risk and product type. Like all investments, real estate should be evaluated based on its actual and anticipated risk-adjusted return(s). Understanding risks allows for the development of an investment strategy that can both meet long term objectives as well as retain alignment with risk tolerance. Direct real estate investments broadly fall into four risk categories noted in the subsequent table—with increased return expectations aligned with increased risk.

STRATEGY	ASSET CHARACTERISTICS	INVESTMENT ATTRIBUTES
CORE	• High Quality Property • Well Leased • Well Located • Low maintenance	• Risk: Low • Debt: Low to Moderate Debt • Returns: 7 - 9% Levered IRR
CORE-PLUS	• Well Located • Limited deferred maintenance • Moderately leased	• Risk: Modest • Debt: Low to moderate • Returns: 10 - 12% Levered IRR
VALUE ADD	• Moderate deferred maintenance and management • Often has a dated appearance & systems • Moderately to Poorly leased	• Risk: Relatively High • Debt: Moderate • Returns: 13 - 16% Levered IRR
OPPORTUNISTIC	• New Development or Substantial Redevelopment • High Level of Deferred Maintenance • High Level of Vacancy • Possible secondary locations	• Risk: High Level • Debt: Moderate • Returns: 17%+ Levered IRR

These risk classes can be further defined based on the product or investment type. Broadly speaking, the major real estate product types are office, apartment (multi-family), retail, and industrial. These comprise most of the investing segments in the U.S. and globally. Smaller segments include hotel, self-storage, student housing, senior housing, medical-office (including subsets such as dialysis clinics), timber, and agricultural lands. The following chart provides a relative proportion of how institutional investors have made their investments in the U.S. markets.



Source: NCREIF National Property Index, 3Q18.

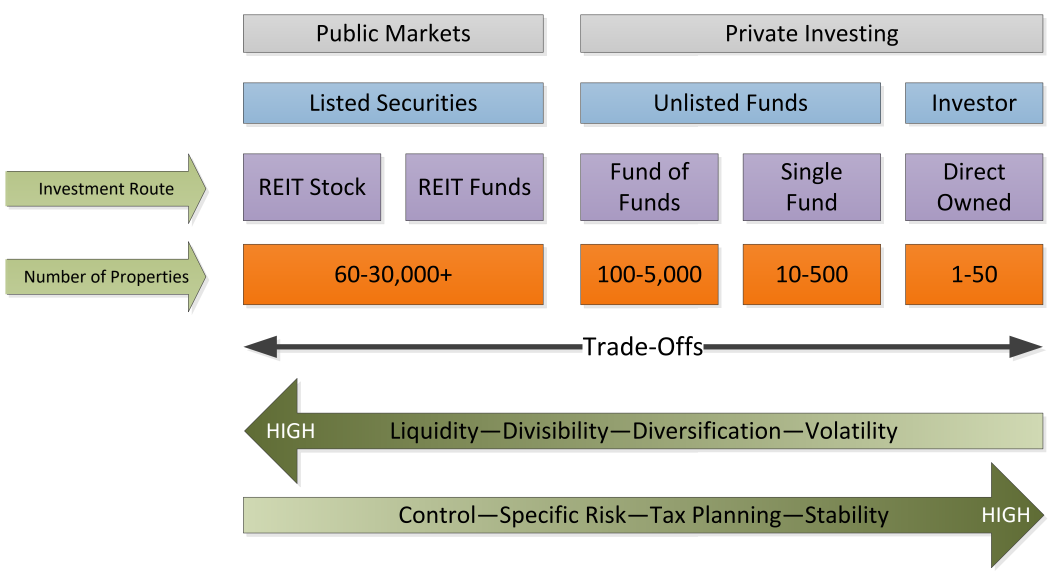
It is important to note that the investment universe includes opportunities in each of the major risk categories for each of these major asset types. For example, there are opportunistic apartment projects (new development or significant re-development) as well as core office investments (new, high-rise in growing urban areas such as Seattle). These product types also have differing characteristics that should be recognized with respect to investor risk tolerance and portfolio performance. One of our best examples of this is the office product. With long term leases comprising the bulk of the generated income stream, office investments are also subject to required capital investments associated with tenant turn-over—specifically tenant improvements and commissions. New (and renewing) tenants will typically want a significant landlord contribution to tailor the office space to their needs. Over time, this necessarily creates swings in the property's distributable cash flow. Apartments tend to be more management intensive, but also benefit from relative vacancy stability and low turn-over costs. As noted below, office (for example) has had the lowest returns and highest volatility over the 27-year period from 1990 to 2017.

	Apartment	Industrial	Retail	Office
Avg. Return/Year	9.1%	8.9%	8.8%	7.3%
Volatility	7.7%	8.5%	7.4%	10.0%

Source: PREA (PREA Research), NCREIF Data. Note: PREA chose 1990 as a start as NCREIF data was limited prior to 1990 in some sectors (apartments).

Real Estate Investment Vehicles

The vehicles for investing in real estate are equally wide, and each carries some trade-off to investors. These factors include liquidity, control, investment volatility & correlation with other asset classes, tax planning, and diversification. Largely speaking, the investor has three major options: the public markets (Real Estate Investment Trusts—REITs and funds of REITs), private (unlisted) funds, and direct ownership.



For comparative purposes we are excluding mortgage REITs as these offer a differing risk/return threshold and are more closely aligned with the debt markets and the risk-adjusted returns of debt instruments. Also, we are not including a review of the differing costs for managing each investment option. Our research in this area indicates the total management and administrative costs do not differ dramatically among REIT, private funds, of direct investing options. This is not to say that costs should not be viewed carefully—they should—but the narrow range of each in general suggests they are not key influencer in reviewing the differing investment options.

REITS

Investing in the public markets (REITs and funds of REITs) is relatively straight-forward and offers several benefits. This option provides one of the easiest methods to create an immediate investment. As a traded security, they offer daily liquidity, good transparency, sector diversification (number, location, and/or type of properties) and a relatively low commitment level. At the same time, their investment performance tends to tie more closely with the broader equity markets—meaning they have a greater volatility with respect to total portfolio performance. They also offer little flexibility for tax deferral or tax planning.

Real Estate Funds

The use of real estate funds provides some of the diversification and scale benefits of REITs, while often allowing for a more targeted risk strategy. Specifically, there are many investors looking to complement their portfolios with higher return metrics available with value-add or opportunistic funds. Funds are typically defined by risk, and identified consistent with the risk table presented earlier, i.e. as core, core-plus, value add or opportunistic. Benefits of fund investing include good sector diversification (scale), a defined strategy/approach and dedicated professional management. Funds, however, also tend to have a prescribed, finite life cycle, including funding, acquisitions, stabilization, and (ultimately) liquidation. While the sponsor/ manager may have some discretion to extend the fund's term, closing out in a down market can result in a less favorable outcome than the control and patience available to the investor with a traded (REIT) security or direct ownership. Funds also require a greater commitment level than the public markets, have limited liquidity and control provisions, and little, if any, ability to engage in meaningful tax planning.

Direct Ownership of Real Estate

Directly investing in real estate provides several benefits not available within the public (REIT) or private fund structure. These include full control of the asset, tax deferral(s), full transparency, true portfolio diversification, and multi-generational income and value-preservation. Control provisions are worthy of identification as they in effect dovetail with some of the other benefits discussed. Under direct ownership, the investor has full control regarding its operation, financing/debt levels, and planned hold period. Owning direct real estate allows for the tax benefits of both asset depreciation and deferral of taxes even on a sale/gain.[4]

Ownership and close monitoring by the asset and property managers allow for frequent and accurate reporting of the property's performance together with periodic reviews of extended, longer term (10-year) performance and modeling. Interestingly, the illiquidity of

[4] Assuming the investor successfully uses a §1031 tax-deferred exchange to a like-kind property and investment.

direct-owned real estate is often also viewed as a benefit. When looking at a multi-generational investing strategy, including direct-owned real estate creates a natural barrier to the "quick sale" or what may be an undesirable liquidation and distribution of assets.

Families and family offices can also benefit from a somewhat unique competitive advantage in the marketplace when acquiring assets. A recent example was based on an alignment between buyer and seller on the longer-term vision and care of the property. While pricing was important to the seller, the shared vision for long term, multi-generational care and pride-of-ownership made the difference in awarding the purchase to our client. The other buyers (local and institutional) were unable to convey the same alignment of values that mattered to the seller.

Related to this, direct ownership of real property also uniquely creates an opportunity to demonstrate and translate family values. There is something to be said for owning a "pride of ownership" asset. They are often widely respected and treasured—by both families and communities. The quality of a property and its presence in the market can often translate to the quality and "permanence" of the family. And there is often much more. A key refrain we hear often is the need to transfer family values to future generations. Those of integrity, hard work, creating value, and community. This can be challenging when looking at a stack of investment return reports and account statements. Visiting real properties, however, provides an exposure to real world assets. Seeing first-hand how a coordinated team is required to run a property is very educational. Property managers, leasing experts, maintenance engineers, landscapers, housekeepers, and of course all the suppliers and outside maintenance staff contribute to a successful property. And, of course, there are ultimately the customers (tenants) who must be well served in order to retain them and pay the rent.

Real Estate Mentorship

At Trinity we are often involved in providing mentoring and training support for the family and future generations. We hope our enthusiasm and passion for the business translates effectively, and it is very enjoyable to see the younger family members gaining an understanding of the value of owning real estate. One example was a site visit with some of the younger members of the family to a mixed use/office building in downtown Seattle. During the tour, the engineer was able to explain how we need to manage the trash every day—and the use of a garbage chute and compactor. Quickly thinking of a good analogy, he offered the compactor worked just like the compactor room in Star Wars. "Wow" said the boys—and they continued to talk about it for the rest of the tour. We're sure this resounded quite a bit more than the stack of account performance reports sitting back at the office.

Summary

At Trinity Real Estate, we are passionate about investing in direct commercial real estate and feel it offers a breadth and depth of investment risk/reward profiles that you are not able to find in other investment vehicles whether private or public. We are uniquely positioned at Trinity to assist family offices in creating, preserving and enhancing a direct commercial real estate portfolio.

About the Author - Richard Leider

Over the past 30 years, Richard has provided real estate advisory, development, and investment services to family office and institutional projects valued at more than $2 billion. His product experience includes office, residential, retail, hotel, mixed-use, and industrial properties, totaling over 3.6 million square feet. As an industry expert, Richard has been referenced in the New York Times and has been a contributing source for the annual Urban Land Institute/PricewaterhouseCoopers publication *Emerging Trends in Real Estate*. He served on the board of directors of the Pacific Real Estate Institute and is both a past president and former national board director for the National Association of Industrial and Office Properties.

About Trinity Real Estate

Trinity Real Estate (TRE) provides comprehensive, personalized real estate services and investment strategy to West Coast family offices and institutional investors. TRE's hands-on, high touch, and full-service approach has led to the management, development, and repositioning of more than $3 billion in assets since its founding in 2001. These assets span all sectors of the real estate market including office, industrial, multifamily, residential, hospitality, and mixed-use. TRE's objective is to create, enhance, and preserve real estate assets that produce strong long-term returns for its clients.