



Investment Merits of Private Real Estate

More than five years into the Federal Reserve's zero-interest-rate policy, the current investment landscape remains marked by historically low interest rates and tepid economic growth. Investors, particularly those who prefer a healthy income stream, are left to consider paltry cash yields from traditional stock and bond investments. With bank accounts paying pennies, the 10-Year US Treasury bond yielding 2.6%, and the average US stock paying 2.2% in dividends, where are prudent investors to turn for steady, inflation-protected cash flow? One source is private real estate.

Privately owned and cash-flow generating properties offer attractive, growing income streams, while also minimizing the daily volatility that comes with public markets. Below we outline some important reasons to consider private real estate as part of a diversified investment portfolio:

Higher Yield:

In comparison to the current 4.3% yield of an index of publicly traded REITs, stabilized private real estate often generates current cash yields of 7% or more. In exchange for forgoing liquidity for some extended period of time, investors can expect to be compensated with higher returns for a comparable amount of risk. Additionally, the legal structures of many private real estate investments allow non-cash depreciation expense to be passed through to investors, thereby partially sheltering the cash flow from income taxes.

Stability:

While private real estate carries well-defined risks to principal value, the illiquid nature of the asset class removes a significant portion of daily volatility. Absent the requirement for daily pricing and liquidity, private real estate is valued less on short-term market vagaries and more on the long-term, underlying fundamentals of each property. Features such as predictable cash flow from



John T. DiPasquale
Co-Managing Partner
Cobblestone Capital
Advisors, LLC

PROFESSIONAL OPINION

Jason S. Garlock, CFA
Director of Investments



property leases, carefully measured operating costs and long-term fixed mortgages provide for more stable returns relative to many risk assets. Likewise, since a substantial portion of the return is generated from income as opposed to capital appreciation, there is a "bird-in-the-hand" dynamic that offers more certainty and less stress for the investor.

Diversification:

Diversification benefits come in multiple forms. First, investors in private real estate are afforded the ability to diversify exposure across a multitude of subcategories within the broader real estate market. Since risk and return assumptions vary greatly across such categories (Multi-Family Housing, Commercial, Retail, Hospitality, etc.), investors can more closely align specific investments with their objectives depending on overall macro-economic conditions. In addition, because private real estate projects are driven by their local market conditions, there is substantial benefit to diversifying geographically away from the investor's home market. Finally, since well-structured private real estate investments specifically minimize equity market and interest rate risk, diversified balanced portfolios that include a private real estate component have a noticeably more attractive risk-return profile. In the current investment environment where global risk assets have grown increasingly correlated, such diversification attributes are critical to achieving consistent investment success.

Inflation Protection:

Keeping pace with inflation should be of paramount concern to all investors. While inflation is currently benign, that is not likely to be the case as the impact of recent monetary policy is fully realized. Whereas the return from traditional bonds will likely struggle to keep up with the cost of living increases in coming years, private real estate investments are largely insulated from rising inflation. Importantly, property owners maintain the ability to raise rents over time to keep pace with inflation and, at times like the present, can lock in fixed-rate financing at lower rates while inflation is contained.

Factors to Consider Before Investment

While the benefits of private real estate are well documented, you should be mindful of the potential drawbacks before adding this type of investment to your financial portfolio. Historically, access to private real estate deals has been reserved primarily for larger institutional investors with the time and resources required to source and perform due diligence on potential properties and deal sponsors. In addition, the large purchase minimums – usually well in excess of \$100,000 – make it difficult for all but the most affluent investors to properly diversify their holdings in this space. Private real estate deals with lower minimums often lack adequate diversification, carry burdensome distribution expenses that diminish the net returns to shareholders, or both. Investors should also be mindful that liquidity constraints, which can approach 5-10 years, are often accompanied by lack of readily available information about the underlying investment. Since years can transpire between financial transactions, it may require extensive analysis to effectively monitor the operating performance and value of the asset. There are other financial risks to consider as well. First, all private real estate investments are subject to the general economic condi-

tions of the local and national economies in which they operate. Even the best real estate projects can be impacted by a major financial recession or a significant change in local economic conditions. Secondly, most private real estate deals employ some form of financial leverage. When employed sensibly, leverage can boost the stable returns of private real estate. However, excess leverage can rapidly wipe out the equity of an otherwise sound project. In light of the enormous breadth and variety of private real estate investments, significant due diligence is paramount to understanding the multitude of variables impacting this type of investment.

Finally, K-1 accounting is a typical requirement of private real estate investment. It is best to consult with your tax advisor on these logistics to understand the repercussions with regard to your income tax filing burden.

Summary

Adding private real estate investments to a properly diversified portfolio offers the potential for substantial levels of income while preserving capital, minimizing principal volatility, and retaining the opportunity for income and capital to grow over time. There are meaningful risks and factors to consider before making a commitment. Be sure to consult with a professional investment manager to assist in determining whether a private real estate investment would be a suitable complement for your portfolio.

Disclosure: Information provided in this article should not be construed as a solicitation to engage Adviser for any services or products. Past performance is not indicative of any specific investment or future results. Views regarding the economy, securities mar-

kets, specific securities or other specialized areas, like all predictors of future events, cannot be guaranteed to be accurate and may result in economic loss to the investor. This article is intended to provide general information only and should not be construed as an offer of specifically tailored individualized advice. ■

Jason S. Garlock, CFA

*Director of Investments
Cobblestone Capital Advisors, LLC
585-473-3333
jsg@cobblestonecap.com*

John T. DiPasquale

*Co-Managing Partner
Cobblestone Capital Advisors, LLC
585-473-3333
jtd@cobblestonecap.com
www.cobblestonecap.com*