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Commercial real estate has emerged as an asset class

By Robert Brunswick
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Some time in 2002, when the Standard & Poor's 500 stock index had bottomed from its technology bust, investors went back to the drawing board and wondered how they could get off the roller coaster.

Amid this search for answers, investors began to discover how the commercial-real-estate industry had emerged from the cocoon where it had slept for most of the 1990s.

The situations and conditions for the sector have improved so much in recent years that institutional and high-net-worth investors, both domestic and foreign, have developed newfound trust and confidence in it as an investment.

Defining changes in the commercial-real-estate industry include access to real-time property information, structural development in the transparency of reporting, [the growth of] public debt and equity markets, increased range of investment vehicles and capital sources, and a well-educated talent pool. The current industry differs significantly from that of the '80s, when commercial real estate could be described as excess development supported by speculation and tax abuses.

Now that the industry has matured, commercial-real-estate investments aren't likely to experience such dramatic booms and busts. Real estate cycles haven't disappeared, but the levels of peaks and troughs are reduced because of the industry's transition.

Growing complexity

The increased variety and available research allows investors, developers and lenders to react quickly to changing market conditions — thereby reducing the likelihood of overbuilding. There is more to it than just the amount of information, however.

The industry now demands more emphasis on the analysis of such information and the educated talent that provides such analysis. The growing complexity of real estate has resulted in more prestigious academic programs dedicated to real estate, hoping to make more sense of the data in ever shorter amounts of time.

The commercial-real-estate industry has demonstrated its maturation through new standards of transparency, established in response to regulators and investors. This step forward adds to the legitimacy of such investments as a major asset class.

The industry also has benefited from capital markets growth.

Since the 1990s, nearly every major investment bank has become an active provider of private equity for real estate. Public markets for real estate have grown significantly, as well.

The public U.S. equity real estate investment trust market had swelled to more than $387 billion as of March 31, from about $5.5 billion in 1990.

Securitized debt also continues to evolve around real estate. The commercial-mortgage-backed-securities market (nearly non-existent in 1990) has boomed, with U.S. issuance reaching $169 billion in 2005, $205 billion last year and $61 billion in the first quarter, according to Commercial Mortgage Alert.

Additionally, the collateralized-debt-obligation market has made its presence known in commercial real estate, as the public-real-estate debt and equity markets surpass the trillion-dollar status.

Recently, the subprime market has faced significant difficulties. The increased risk and defaults in subprime mortgages have provoked investors to seek safety in Treasuries, thus leading to lower Treasury yields.

The subprime woes caused the yields of triple-B-rated commercial-mortgage-backed securities to rise, resulting in wider spreads and pushing lenders to raise their quote spreads on mortgage loans.

Thus far, the spillover effects from the subprime blowup have been minimal to the commercial-mortgage markets. This is due mainly to the majority of commercial mortgages having strong credit ratings and low default rates.

The subprime problems will affect mostly subprime lenders and borrowers.

Sources for commercial-real-estate capital come from a growing range of providers.

Institutional investors have increased their stake in real estate. Many pension funds previously allocated between 3% and 5% of assets to real estate — if they invested in it at all.

Now these funds are targeting between 5% and 10%. Foreign investors also have poured capital into U.S. properties and haven't ignored secondary markets this time around.

There are certainly the "trophy" purchases, but now they are accompanied by a wide range of additional property types.

All these contributions support the view that commercial-real-estate investments are less likely to go through major booms and busts, instead offering a complementary alternative to stocks. In fact, the S&P 500 is more likely to experience the boom-bust roller coaster than commercial-real-estate investments.

Commercial-real-estate prices certainly have risen in recent years, but that is because investors have participated in pushing undervalued real estate back to the risk-return equilibrium.

Over the past decade, commercial real estate has offered higher returns and less volatility than the S&P 500. Comparing quarterly returns over the past 10 years reveals that the sector has a more favorable risk/return profile than the S&P 500.

Less risk and higher returns are the concrete reasons why investors have turned to commercial-real-estate investments.

Fortunately, the correlation between overall commercial- and residential-real-estate prices is about 30%. That calculation is based on the past 10 years of quarterly percentage changes of the U.S. House Price Index reported by the Office of Federal Housing Enterprise Oversight and the Commercial Properties Price Index, maintained by the Massachusetts Institute of Technology Center for Real Estate, which is in Cambridge.

The correlation between housing and sectors such as industrial and office is much lower (17% and 22%, respectively). Factors that influence commercial-real-estate cycles remain more dynamic than those of residential properties.

For instance, global trade affects demand for warehouses but doesn’t directly affect housing demand. Therefore, commercial properties and homes don’t necessarily move in the same direction.

Although commercial real estate has undergone a paradigm shift, it isn’t impervious to business and economic cycles. However, there is “improved resistance” to these.

In real estate, oversupply damages the market, and the recent flood of demand for buildings now may entice developers to start building. However, other commercial-real-estate participants, along with other market forces, such as high construction costs, have kept new commercial construction in check.

The modern commercial-real-estate industry has come a long way over the past couple of decades. These changes allow talented and educated commercial-real-estate professionals to analyze conditions better, respond quickly to change and more effectively utilize capital resources.

Commercial and multifamily real estate have evolved into legitimate asset classes that belong in portfolios seeking diversification and safe returns.

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