INVESTMENT PLANNING

Commercial Real Estate—an Inflation Hedge?

By S. Timothy Kochis and Lauren Pressman

Allocation to real assets can play an important role in a long-term investment portfolio and, in particular, as a hedge against inflation risk.

Assets that are tangible or physical in nature encompass a wide range of investment strategies whose values are sensitive to inflation. Examples of real assets represented in portfolios include real estate and often commodities such as oil and gas, metals (precious and industrial) and agricultural assets, like grains and livestock. Commodities in particular provide significant and unique protection against inflation because of their direct relationship to price changes and the often very slow process of exploration, mining, planting, feeding, transportation, etc. to cause supply to respond to increasing demand.

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Similarly, commercial real estate has demonstrated that it is a good, albeit partial, hedge against inflation. The reasons why are fairly simple.

First, inflation causes a rise in construction costs, which, in the short run, will limit new supply. Why is this the case? Because real estate developers/investors target a certain return on cost (yield) prior to starting a new development. If the numerator (net operating income derived from rents, less expenses), does not rise sufficiently to offset an increase in the denominator (development costs), then groundbreaking on new projects will be postponed until projected net operating income rises enough to meet the desired yield.

Because of this constrained supply in the short run, inflation, then, fuels growth in rents. As a result, growing rents cause an increase in value of existing properties.

Of course, inflation will drive up expenses as well, but many commercial real estate leases are structured so that the tenants bear most or even all expense increases, insulating property owners from much of the burden of higher expenses.

The combination of these factors translates into higher market rents, which eventually feed higher operating incomes. In some real estate sub-asset classes such as hotels and apartments, which generally have shorter lease terms, the impact can happen relatively quickly. In others, with longer average lease terms such as retail and office properties, it may take longer for the impact to filter through. However, real estate investors will often price in the *expectation* of future rent increases, and will give existing owners "partial credit" for this expectation in their current valuation of properties, even if the rent increases have not materialized for that property quite yet.

Mr. Kochis is President, International Ventures, Aspiriant, San Francisco, California, and is a member of the CCH Financial and Estate Planning Advisory Board. **Ms. Pressman** is Director, Real Estate Research, of Aspiriant.

This valuation increase occurs by a fall in the "capitalization rate" (or yield, calculated by the net operating income divided by the property value) used to value a property. Essentially, investors lower the discount rate they are using to value existing cash flows, resulting in a higher estimated property value, in expectation of greater cash flows ahead.

Why, then, is commercial real estate considered only a partial hedge against inflation? The reasons are a bit more complicated and have to do with the condition of the space markets, real estate's sensitivity to interest rates, and how real estate is owned (direct private ownership or through a securitized vehicle such as a real estate investment trust (REIT)).

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One clear lesson from the early 1990s is that owning real estate is not an effective hedge against inflation if there are large oversupplies of space in property markets. High vacancies inhibit a landlord's ability to raise rents, while expenses might respond more immediately. During this period of time, even though consumer prices rose steadily, commercial property prices collapsed. In contrast, from 1979 to 1982 (a period of high inflation, peaking at 15 percent, and a relatively healthy space market measured by the vacancy rate), commercial real estate outperformed stocks and bonds, returning approximately 17 percent vs. 11 percent and six percent, respectively.

The collapse in the early 1990s was caused by massive overbuilding. The success of the immediate prior period bred its own failure by encouraging too much new building.

Unlike that period, additions to new supply over the last ten years have been relatively moderate. As a result, today's space markets are not as vastly oversupplied as in the early 1990s. In many cities, landlords have already begun to raise rents as job growth has modestly resumed. If inflation were to rise significantly (but we don't think that significant increases in inflation are especially likely), we would expect this rental increase impact to amplify.

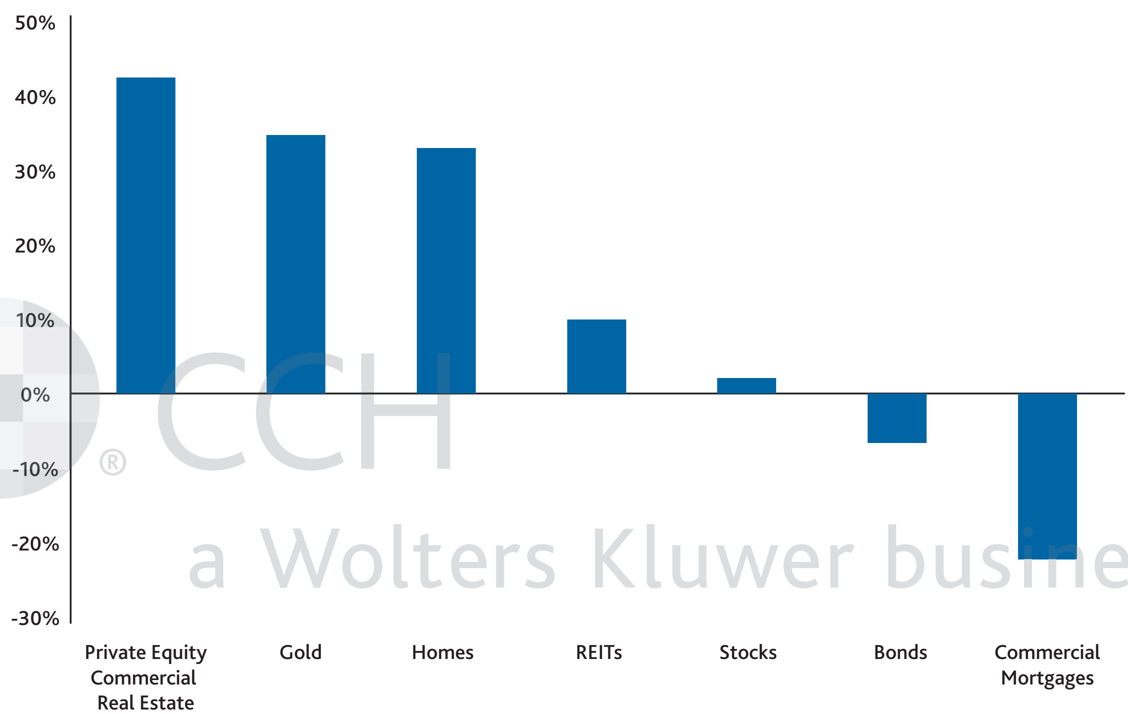
A second reason why real estate may act only as a partial hedge is that commercial real estate is impacted by interest rates, as most acquisitions are at least partially financed by debt. Higher interest rates, which usually coincide with inflationary impacts, will affect the price a buyer is willing and able to pay to meet its required rate of return, thereby dampening real estate value increases.

Research conducted by the Property and Portfolio Research (PPR) firm has indicated that, over the period 1978-2009, while privately held commercial real estate provided an excellent hedge for inflation, REITs have not been an effective inflation hedge, especially against unexpected inflation. Several theories can account for this performance of REITs during inflationary periods. It is important to note that until the mid 1990s, the REIT industry was dominated by mortgage REITs, which provide debt financing for commercial or residential properties. Mortgage REIT values are negatively impacted by rising interest rates. The rise of equity REITs (REITs that own and operate properties) occurred after the passage of the Tax Reform Act of 1986. Today, equity REITs represent a large percentage of total REIT exposure. The research done to date on equity REITs performance during inflationary periods has been inherently limited by the fact that since the mid 1990s, inflation has never exceeded 3.85 percent in the US. More recent research on equity REITs seems to indicate a positive correlation with inflation, while mortgage REITs have a significant negative correlation with inflation.

As we have seen with the extreme price volatility over the last few years, REIT performance can be affected as much or more by general stock market investor sentiment than underlying property valuations. Some commentators believe that REITs are part stock, part bond, and only part real estate. If, as today, the REIT investor base is looking for a current yield above that of a 10-year Treasury bond, those investors may flee if interest rates rise and, at least in the short term, REIT values will likely suffer. However, if the ownership base then shifts to investors owning REITs because of their real estate qualities (versus their bond-like qualities), REITs should fare pretty well in an inflationary period, in spite of their interest rate risk.

Nevertheless, although REITs' ability to act as an inflation hedge may be dampened in comparison to privately owned real estate, we do expect equity REITs to exhibit an increasingly positive correlation to inflation, particularly in periods of above-average inflation growth. Consequently, if we do face an inflationary period, we expect commercial real estate owned by our clients, whether privately or through REITs, to provide a valuable inflation hedge in their investment portfolios.

Correlation of Asset Class Returns with Inflation; 1978-2008



Source: S&P; Barclay's Capital; NAREIT; NCREIF; Moody's Economy.com; PPR