Plan asset diversification: Why real estate

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Low correlations to stocks and bonds and other investment features can make REITs a prudent investment alternative for defined contribution plans.

Misperceptions about real estate have led to under-representation in DC plans

Retirement plans must be diversified, according to both the Employee Retirement Income Security Act of 1974 (ERISA) and generally accepted investment principles. In 401(k) and similar participant-directed plans, this diversification requirement applies to the plan's investment lineup. But beyond this basic concept, there is little consensus on how to develop a diversified lineup—that is, which asset classes should be included.

Most investment professionals who handle large defined-benefit pension plans, endowments and foundations already understand the potential benefits of including allocations of real estate and other real assets, and frequently include real assets strategies in their portfolios. However, this view is not yet widely shared by defined-contribution plan sponsors.

Why? Some plan sponsors may be concerned about including asset classes such as real estate investment trusts (REITs) in their plan due to a lack of familiarity. Others may think it's unnecessary, since many participants already own real estate in the form of their home. In our view, neither of these are valid reasons for excluding real estate from DC plans.

KEY TAKEAWAYS

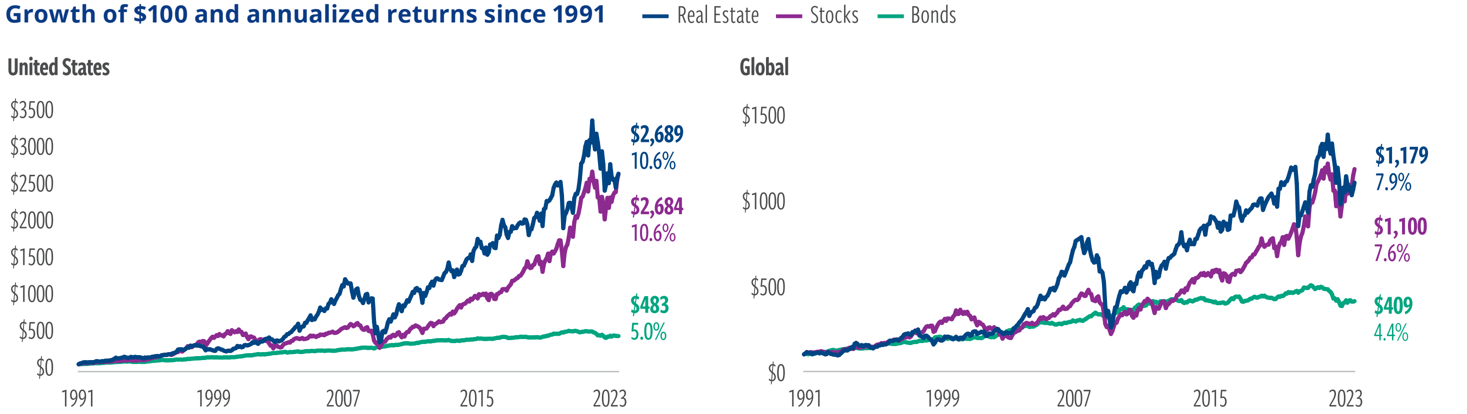
Plan sponsors often overlook REITs for inclusion in DC plans due to misperceptions about the asset class.

The potential for enhanced returns and diversification with REITs tends to offset periodic volatility.

Though a home can be a valuable asset, it is not a substitute for including income-producing real estate in portfolios.

EXHIBIT 1

Growth of $100 and annualized returns since 1991



At August 31, 2023. Source: Morningstar, Cohen & Steers.
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REITs' potential benefits tend to offset periodic volatility

Reservations about REITs often stem from the argument that REITs are too volatile. We believe this fear fails to take into account factors that favor the inclusion of REITs in a diversified portfolio:

- The market movement of real estate investments has historically not been highly correlated with stocks and bonds.
- Long-term historical returns indicate that REITs have the potential to enhance risk-adjusted returns.
- REITs offer daily liquidity through trading on public stock exchanges.

But what about volatility? There have been times over the last 30+ years when REITs have been more volatile than other investments. But in the context of retirement plans, it's important to remember that REITs typically make up only a small portion of an overall portfolio—generally 5% to 10%—so an allocation to real estate is unlikely to increase the volatility of an overall portfolio significantly. In addition, the strong historical returns of real estate suggest that the benefits of an allocation to real estate will tend to offset the volatility over the time horizon for 401(k) investing (Exhibit 1).

Homeownership is not a substitute for real estate in portfolios

What about the second factor? If a participant owns his or her own home, shouldn't that be considered a real estate investment?

Home ownership may be desirable for many people, and a home can be a valuable asset over time. But a house is generally considered a consumption item, not an investment. Rather than generating income, a primary residence consumes it in the form of mortgage interest, real estate taxes, insurance payments, utility expenses and the costs of repairs and maintenance. In contrast, REITs generate rental income from real estate such as commercial, industrial and multi-family residential, which is then distributed to shareholders via tax-advantaged dividends. It's the opposite of a personal home, which consumes income and which may not be liquidated in a person's retirement to produce income or gains.

> Unlike a home, REITs are liquid investments in income-generating real estate, providing access to many property types and geographies.

Furthermore, publicly traded REITs, like mutual funds, are highly liquid investments. A REIT fund will also typically be diversified across companies that focus on different types of properties and geographic locations, typically representing thousands of underlying properties. By contrast, a home is a relatively illiquid asset whose investment risk is not diversified. Instead, it is highly concentrated, making it vulnerable to unexpected changes in demand within its neighborhood, whether due to shifting demographics, natural disasters or the local business environment.

For fiduciaries looking to provide diversifying alternatives in their investment lineup, real estate offers the prospect of enhanced risk-adjusted returns. We discuss this issue in more depth in other white papers published in coordination with Cohen & Steers, Inc.

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