Morgan Stanley

INVESTMENT MANAGEMENT

Stable Income "Carrying" Core Real Estate Performance: Core Investing for the Long Run

REAL ASSETS | REAL ESTATE INVESTING TEAM | INVESTMENT INSIGHT | MARCH 2017

AUTHORS

REAL ESTATE RESEARCH & STRATEGY TEAM

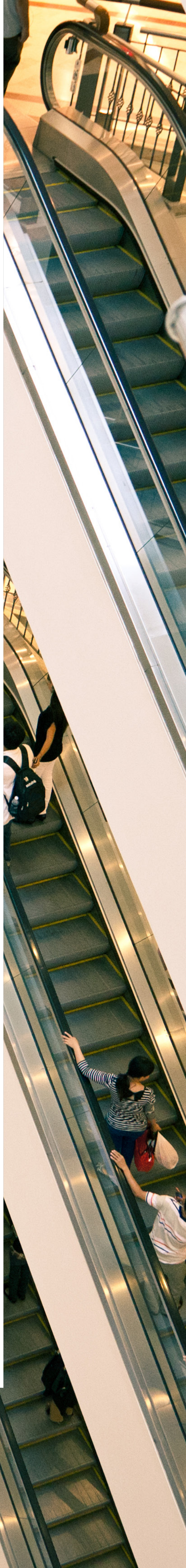
Introduction

In 2002, Daniel Kahneman won the Nobel Prize in economics for his work in a subfield called "behavioral finance".[1] This field, which Kahneman pioneered (along with Amos Tversky and Richard Thaler) in the late 1970s, attempts to explain why economic decision making often differs from what the neo-classical theory suggests "rational actors" should do.

One of the key take-aways of behavioral finance concerns how investors perceive and manage risk. The prior theory of "rational expectations" claimed that investors accurately discounted future events and did not leave money on the table. However, behavioral finance posits that the fear of loss is more powerful than the prospect of gains. Psychological barriers like this may help explain how investor "risk premiums" seem to vary over time, whereas the rational expectations theory would argue that investors' required returns should be time invariant. One of the several risk premiums that have been identified is the so-called "carry premium", which we define as the yield spread on commercial real estate to the risk free rate (i.e. short term U.S. government debt). We believe the carry premium for core real estate today is currently at an attractive level.

Behavioral finance research suggests that contrary to the random walk theory, market sentiment, luck and noise drive near-term fluctuations in prices. Meanwhile, fundamentals and market insight are the keys to long-run returns. Thus, investors should avoid reading too much into the daily noise surrounding the markets and instead focus their attention on the long run. In this paper, we contend that the probability of a U.S. recession

[1] The Sveriges Riksbank Prize in Economic Sciences in Memory of Alfred Nobel 2002". Nobelprize.org. Nobel Media AB 2014. Web. 25 Jan 2017. <http://www.nobelprize.org/nobel_prizes/economic-sciences/laureates/2002/>



in the near term remains low and that short term risks to commercial real estate are muted. Furthermore, we believe that because of its strong carry premium, core real estate remains an attractive investment compared to traditional risk-assets and cash. Finally, we will assert that investors can take advantage of current fear over the prolonged market cycle and negative market sentiment to find attractive entry points for long-term investments.

The Cycle

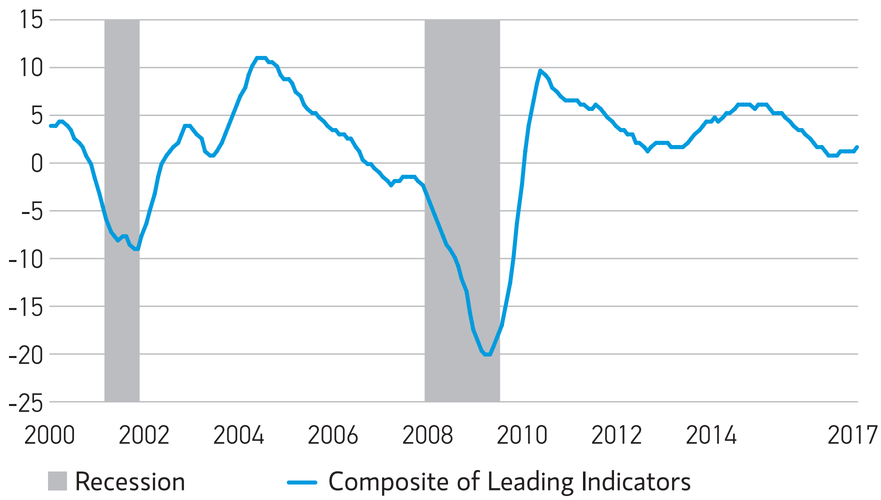
One common investor fear today concerns the current economic cycle. This fear usually comes with the view that the current expansion is 87 months old, compared to a post-war average length of 60 months. However, economic expansions do not have an expiration date; expansions end because of built up imbalances in the economy. A recent economic letter from the Federal Reserve Bank of San Francisco underlined this point, summing up their findings: "… based only on age, an 80-month-old expansion has effectively the same chance of ending as a 40-month-old expansion. Therefore, the current recovery is no more likely to end simply because it is approaching its seventh birthday."[2]

DISPLAY 1

Leading Economic Index

Conference Board composite of economic indicators

YoY, 3 month moving average



Source: The Conference Board, Moody's Analytics, MSREI Strategy, data as of February 2017.

We currently do not see signs of structural imbalances building within the domestic U.S. economy. Importantly, under the new U.S. administration, one might expect that supportive fiscal policy coupled with only modest trade protectionism may provide a near term boost to GDP growth. While interest rates are now broadly expected to increase over the near term horizon, higher interest rates do not necessarily translate directly into higher cap rates, and even if cap rates rise, higher economic growth should translate into higher NOI growth offsetting any negative impact on values from higher cap rates.[3] Household debt burdens remain low, while incomes are rising at a faster pace than inflation. Favorable labor dynamics are keeping consumer confidence high, which is evident from both survey data and in persistently strong auto sales.[4] In the corporate sector, fundamentals appear to be improving with the drag from a stronger dollar and the steep drop in energy prices abating. With these headwinds fading, the "profit recession" looks to be ending, which should support additional corporate capital spending and may boost overall productivity. While corporate debt appears high relative to GDP, the duration of this debt and low yields make it seem more manageable. Moreover, corporate debt as a percentage of corporate assets remains low.

Homebuilding, historically a long-leading indicator of the economy, continues to trend upwards with a favorable demographic tailwind of the millennial generation supporting additional growth. Finally, while lending standards are tightening for corporates and commercial real estate, broadly speaking credit creation continues to be supportive of growth but not excessive relative to GDP. To summarize, above we track the Conference Board's Leading Economic Index which remains in expansion.[5] The year-over-year change in the index has historically provided an early warning, usually turning negative at least one year before the start of a recession.

[2] Rudebusch, Glenn D. "Will the Economic Recovery Die of Old Age?" Federal Reserve Bank of San Francisco, 8 Feb. 2016. Web. 23 June 2016

[3] For further analysis on the relationship between cap rates and interest rates, please see our paper *Frozen on the Rates*

[4] Auto sales are seen a proxy for consumer confidence as they have historically been more sensitive to cyclical fluctuations as consumers pull back on big ticket durable goods when they are losing confidence in the economy

[5] The Conference Board Leading Economic Index includes average weekly hours (manufacturing), average weekly initial claims for unemployment insurance, manufacturers' new orders (consumer goods and materials), ISM index of new orders, manufacturers' new orders (nondefense capital goods excluding aircraft orders), building permits (new private housing units), Share prices (S&P 500), Conference Board Leading Credit Index, interest rate spread (10-year Treasury bonds less federal funds), average consumer expectations for business conditions

High Carry Return

The case for holding real estate over the long run is well known. Since 1992, real estate has outperformed cash (proxied by the yield on 90-day Treasury Bills) by an annualized rate of 670 basis points on a total return basis. For real estate, 78% of this total return is derived from the income component.

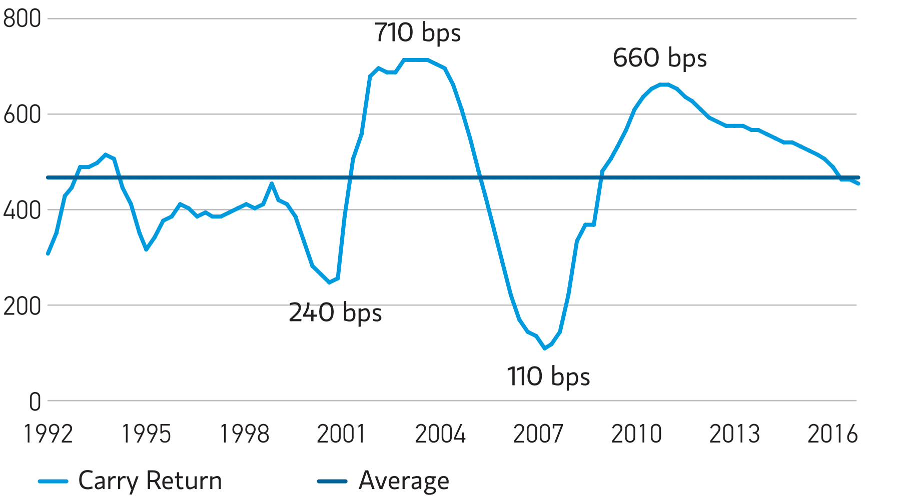
However, while the case for real estate over the long run seems strong, another concern shared by many market participants is that current real estate prices are near peak and nominal cap rates are at or near historical lows. Our case for core commercial real estate stems from the attractive carry premium that core real estate provides relative to other asset classes such as stocks and bonds. Carry is an investment term originally used by currency traders to describe the strategy where they would borrow money in one currency with a low interest rate and invest in another with a higher interest rate.[6] Research has shown that the carry return, which is defined as an asset's return assuming that prices remain the same, is predictive of future returns across many asset classes.[7] Conceptually, the version of carry used here is equal to the more familiar concept of the yield spread.

To calculate the carry return for real estate, we take the trailing-twelve month income yield and subtract out the 90-day U.S. Treasury Bill yield (which we use as the return to cash). Historically, the current yield for real estate has averaged a 470 basis point spread to the cash yield.[8] Thus, with cash yielding just 0.5% today and core real estate yields at 4.8%[9], the carry premium for real estate is currently 430 basis points. Thus, the carry premium for core real estate is only slightly below its historical average.

DISPLAY 2

Carry Return

NPI TTM Income Yield Less Cash Yield, Basis Points



Source: NCREIF, Board of Governors of the Federal Reserve System, MSREI Strategy, data as of 3Q 2016.

Core Investors Are in it for the Long Run

Short-term price fluctuations are extremely difficult to predict and we believe represent more noise than signal. Instead, we believe investors in core commercial real estate should focus on a seven- to ten-year investment horizon where asset selection and manager skill will ultimately drive returns. Rather than reacting to negative sentiment shocks, we would prefer to utilize temporary sentiment-driven market weakness as opportunities to enter at an attractive price. This is particularly true in today's investment environment where carry is favorable and the case for a prolonged fall in real estate prices appears weak.

If we assume that NOI increases by 3.6% over the next year, real estate would be expected to outperform cash by 600 basis points.[10] Therefore, investors who are switching to cash over real estate are making the assumption that real estate prices must be poised to fall by at least 2.4%.[11] For this decline to occur, cap rates would need to rise by 30 basis points over the next year. For reference, CoStar forecasts that cap rates will increase by just 5 basis points by the end of 2017.[12]

[6] Ralph S.J. Koijen, Tobias J. Moskowitz, Lasse Heje Pedersen and Evert B Vrugt, "Carry", Working paper, August 2013

[7] Ibid.

[8] NCREIF, U.S. Board of Governors of the Federal Reserve System, MSREI Strategy, data as of December 2016

[9] NCREIF, U.S Board of Governors of the Federal Reserve System, MSREI Strategy, data as of December 2016; real estate yield represented by the trailing-twelve month income yield on the NCREIF Property Index (NPI)

[10] Equal weighted NOI forecast among major property types (office, retail, logistics, and apartment). CoStar data as of December 2016. Analysis assumes capital expenditures (CapEx) subtract 1.9% from value growth and cap rates remain at 4.8%. Cash assumed to return 0.3% annually. Total return = yield (4.8%) + NOI growth (3.6%) – CapEx (1.9%) = 6.5%. Outperformance = total return (6.5%) – yield on cash (0.5%) = 6.0%. Data as of December 2016

[11] Prices would need to decline by this much in order for commercial real estate and 90-day Treasury Bills to achieve the same return. Total return = yield (4.8%) + NOI Growth (3.6%) – change in cap rate (5.8%) – NOI/cap rate interaction term (0.2%) – CapEx (1.9%) = 0.5%

[12] Equal weighted cap rates across office, industrial, apartment and retail. CoStar data as of December 2016

Since 1992, cap rates have risen by more than 30 bps year-over-year in three distinct periods. During the first (1993 – 1995), cap rates increased by 32% (218 basis points) in the aftermath of the overbuilding in the late 1980s. The second (the dotcom bubble bursting in 2001) saw yields increase by 4% (37 basis points). The final episode where cap rates increased came during the Global Financial Crisis (2009 – 2010) when cap rates increased by 32% (163 basis points). All of the periods of cap rate increases of more than 30 basis points have occurred during or immediately following a recession. Additionally, it is important to note that prior to each of these upward moves in cap rates, the spread over cash was significantly below average – unlike today where the cap rate spread is only slightly below average.

To further illustrate the opportunity cost of missing out on the carry available to real estate investors, we evaluate what would happen if an investor correctly predicted that a recession would occur two years out (i.e., the end of 2018 or start of 2019). Based on today's growth forecasts and yield, that investor would need real estate prices to fall by a cumulative 5.4% to break even on their call. For reference, values declined by just 3.5% from their peak during the dotcom bust.

Strategic Considerations

While the historically high returns of the recent real estate cycle are likely coming to an end, we believe core real estate remains an attractive investment option today. At present, holding cash yields just 0.3%, a 10-year Treasury just 2.3% and equities have an equity yield of only 4.0%.[13] In this light, the carry return from a 4.8% yield on unlevered real estate appears attractive.[14] Additionally, real estate tends to do well in times of high volatility, given the long term hold nature, its predictable cash flows, and diversification benefits. Moreover, we believe the current real estate investment environment remains healthy with the carry return for real estate near historical averages, while the economic cycle looks to have more room to run and new supply remains balanced with demand in most markets and sectors. Therefore, given the current market environment, we offer the following considerations to core real estate investors in the U.S.:

1. **PREPARE FOR HIGHER FINANCIAL MARKET VOLATILITY.** We wrote in *The Odyssey* that the current real estate cycle had seen historically low volatility and this is true of most financial markets over the last five years. With the age of the cycle, we expect investors will overreact and think every sniffle is a reason for a hospital visit. We recommend core investors take a long-term approach.

2. **INVEST IN QUALITY.** As a follow up to the previous point, taking a long-term view is easier with high quality real estate in strong markets. Given the long duration nature of core investing, most core real estate investors will be forced to hold throughout the cycle anyway. Holding high quality real estate that benefits from being the price setter, rather than taker, will help investors during the inevitable downdrafts in the economy. Income growth over the long term has been stronger in primary markets and liquidity is generally better.

3. **BALANCE THE PORTFOLIO WITH DEFENSIVE ASSETS.** Defensive assets have historically shown attractive risk-adjusted returns as they have held up better during recessions and led the initial recovery.[15] Defensive assets can help balance the portfolio by providing core investors with a stable cash flow through a recession. The major defensive property types are grocery anchored retail centers, apartments, self-storage, and medical office.

4. **PICK YOUR RISK CAREFULLY.** All investments carry risk, and picking where you want to take your risk is a key component of successful investing. Instead of reaching for yield in secondary markets, we prefer to take additional risk by staying in primary markets and leveraging experienced asset managers to enhance the real estate. Over the last 20 years, primary markets have outperformed the broader NPI by an average of 46 basis points per annum.[16] Given our belief that the economic cycle still has room to run, taking measured risk over the next 12 – 24 months may help support outperformance.

5. **PLAN FOR A "LOWER BUT LONGER" CYCLE.** The good news about this cycle, in our view, is that it may end up setting a record for length. The bad news about this economic cycle is that the pace of growth, from a historical perspective, has been anemic. Since we believe this growth regime is likely to persist for the next several years, core real estate investors should incorporate this into their underwriting. While interest rates will likely move higher from their currently low yields (with the 10-year at just 2.3%), we do not anticipate that yields will approach the long run average of nearly 6%. Since lower yields are partially driven by lower growth, it also means future rent growth will be lower than historical averages. Investors who appropriately underwrite lower growth will likely end up being more successful over the longer run.

---

[13] Bloomberg, November 28th 2016. The equity yield is the inverse of the price-to-earnings ratio

[14] NCREIF, data as of 2Q 2016

[15] MSREI Strategy, data as of December 2016

[16] Primary markets include New York, Washington DC, Boston, Chicago, San Francisco and Los Angeles. NCREIF, MSREI Strategy, data as of December 2016

Conclusion

While the next recession will eventually hit us, we see little reason to expect it will strike within the near term, suggesting to us that investors should still favor risk assets over cash. Based on our analysis, investors who hold back on core real estate investments in favor of cash are preparing themselves for a 30 basis point move in yields, which given the benign economic environment seems extreme. Our analysis shows that cap rates have moved by that much over the course of a year in only three distinct periods, only one of which occurred independently of economic stress. Since real estate has a high "carry" component to returns and yields remain broadly in-line with historical averages, we believe real estate will still outperform cash on a risk-adjusted basis.

Important Disclosures

The views and opinions are those of the authors as of January 2017, and are subject to change at any time due to market or economic conditions and may not necessarily come to pass. The views expressed do not reflect the opinions of all portfolio managers at MSIM or the views of the Firm as a whole, and may not be reflected in all the strategies and products that the Firm offers.

There is no guarantee that any investment strategy will work under all market conditions, and each investor should evaluate their ability to invest for the long-term, especially during periods of downturn in the market. There are important differences in how the strategy is carried out in each of the investment vehicles. Your financial professional will be happy to discuss with you the vehicle most appropriate for you given your investment objectives, risk tolerance, and investment time horizon.

The document has been prepared solely for information purposes and does not constitute an offer or a recommendation to buy or sell any particular security or to adopt any specific investment strategy. The material contained herein has not been based on a consideration of any individual client circumstances and is not investment advice, nor should it be construed in any way as tax, accounting, legal or regulatory advice. To that end, investors should seek independent legal and financial advice, including advice as to tax consequences, before making any investment decision.

Except as otherwise indicated herein, the views and opinions expressed herein are those of Morgan Stanley Investment Management, and are based on matters as they exist as of the date of preparation and not as of any future date, and will not be updated or otherwise revised to reflect information that subsequently becomes available or circumstances existing, or changes occurring, after the date hereof.

Any index referred to herein is the intellectual property (including registered trademarks) of the applicable licensor. Any product based on an index is in no way sponsored, endorsed, sold or promoted by the applicable licensor and it shall not have any liability with respect thereto.

In addition, real estate investments are subject to a variety of risks, including those related to, among other things, the economic climate, both nationally and locally, the financial condition of tenants and environmental regulations.

EMEA:

This communication was issued and approved in the United Kingdom by Morgan Stanley Investment Management Limited, 25 Cabot Square, Canary Wharf, London E14 4QA, authorized and regulated by the Financial Conduct Authority, for distribution to Professional Clients only and must not be relied upon or acted upon by Retail Clients (each as defined in the UK Financial Conduct Authority's rules).

Financial intermediaries are required to satisfy themselves that the information in this document is suitable for any person to whom they provide this document in view of that person's circumstances and purpose. MSIM shall not be liable for, and accepts no liability for, the use or misuse of this document by any such financial intermediary. If such a person considers an investment she/he should always ensure that she/he has satisfied herself/himself that she/he has been properly advised by that financial intermediary about the suitability of an investment.

Morgan Stanley Distribution, Inc. serves as the distributor of all Morgan Stanley funds.

Morgan Stanley is a full-service securities firm engaged in a wide range of financial services including, for example, securities trading and brokerage activities, investment banking, research and analysis, financing and financial advisory services.

Explore our new site at
www.morganstanley.com/im

1683299 Exp. 1/18/2018 8836696_KC_0217