

Plan Asset Diversification: Why Real Estate?

An analysis by
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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 assets classes should be included.

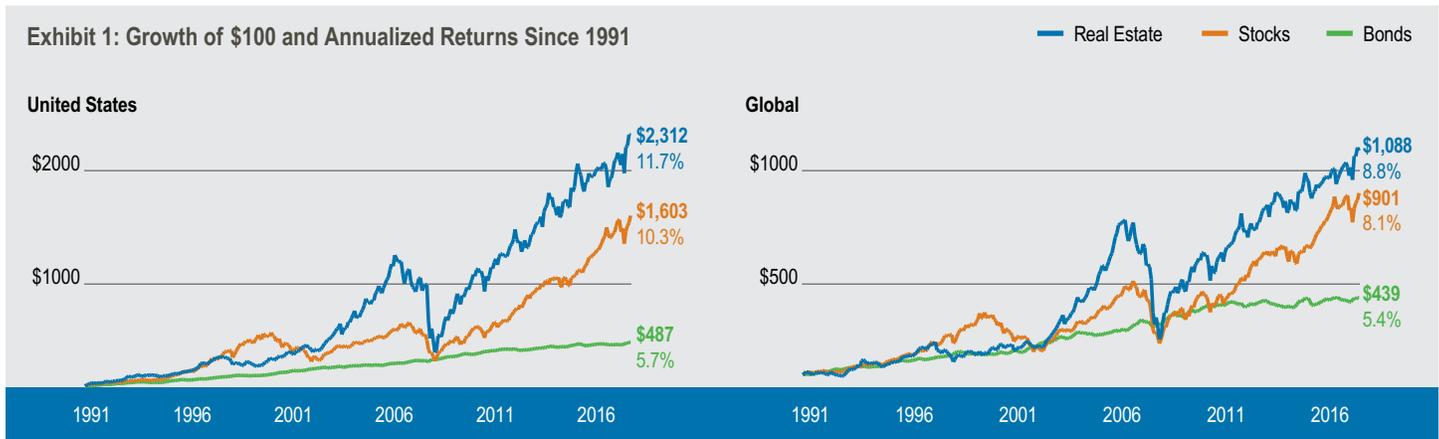
Most investment professionals who handle large defined-benefit pension plans, endowments and foundations already understand the potential benefits of including allocations of real estate, and frequently include real estate strategies in their portfolios. However, this view is not yet widely shared by defined-contribution plan sponsors, even though real estate has been included as one of the 11 core industry sectors in the S&P 500 since 2016.

Why? Some plan sponsors may be concerned about including 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.

On the first issue, 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 20+ 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, as demonstrated in Exhibit 1.



At April 30, 2019. Source: Morningstar, Cohen & Steers.

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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.

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.

We discuss the issue of including REITs in 401(k) plans in a January 2019 white paper published in coordination with Cohen & Steers, Inc., *Real Estate in Participant-Directed Defined Contribution Plans: Fiduciary Considerations* (for professional investor use only).

Index Definitions. An investor cannot invest directly in an index and index performance does not reflect the deduction of any fees, expenses or taxes. U.S. REITs: FTSE Nareit All Equity REITs Index is a free-float adjusted, market capitalization-weighted index of all tax-qualified REITs with more than 50% of total assets in qualifying real estate assets other than mortgages secured by real property. U.S. stocks: S&P 500 Index is an unmanaged index of 500 large-cap stocks that is frequently used as a general measure of stock market performance. U.S. bonds: U.S. bonds: Barclays Capital U.S. Aggregate Bond Index is a broad-market measure of the U.S. dollar-denominated investment-grade fixed-rate taxable bond market, and includes Treasuries, government-related and corporate securities, mortgage-backed securities, asset-backed securities, and commercial mortgage-backed securities. Global real estate: FTSE EPRA/Nareit Developed Real Estate Index (net) is an unmanaged market-capitalization-weighted total-return index, which consists of publicly traded equity REITs and listed property companies from developed markets. Global stocks: MSCI World Index (net) is a free-float-adjusted index that measures performance of large- and mid-capitalization companies representing developed market countries. Global bonds: Barclays Capital Global Aggregate Bond Index provides a broad-based measure of the global investment grade fixed-rate debt markets.

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Fred Reish and Bruce Ashton, the authors of this analysis, are partners in the Employee Benefits & Executive Compensation Practice Group of Drinker Biddle & Reath LLP. They are not affiliated with Cohen & Steers but have been compensated by us to provide this discussion. Cohen & Steers has also provided factual descriptions, charts, and investment information for their analysis.

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