BY MICHAEL J. MCDERMOTT

ILLUSTRATIONS BY JOSHUA GORCHOV

BUILDING INVESTMENTS

REAL ESTATE MAKES ITS CASE AS A FOURTH ASSET CLASS

The renowned New York real estate investor Louis Glickman once told a reporter for the *New York Post* that the best investment on earth is earth. Glickman served up that bon mot in 1957 — 30 years before the cataclysmic stock market crash of '87 and decades before the ill-fated technology bubble had begun to form.

Nonetheless, almost half a century after that pithy encapsulation of his investment philosophy, some of the investment community's most respected strategists are nodding their heads in agreement. "Real estate as an asset class is being viewed more favorably today than ever before in my 24-year career," says Dean Macfarlan, CEO of Macfarlan Real Estate Investment Management, a Dallas-based firm that controls more than half a billion dollars worth of commercial real estate nationwide. Professional money managers have come to view real estate as a fourth asset class, an investment holding worthy of the same consideration traditionally given to stocks, bonds, and cash equivalents in building a portfolio.

To be sure, real estate has been a red-hot investment sector of late. The asset class, as measured by the Morgan Stanley

REIT (real estate investment trust) index, returned almost 27 percent through the first 11 months of 2004, and REITs have "handsomely beat" broader stock market returns for the past five years, notes David M. Darst, chief investment strategist at Morgan Stanley's Individual Investor Group.

That sizzling performance has some pundits casting a wary eye on real estate, even warning of a potential bubble getting ready to burst. "It's easy to talk about real estate as a hot investment right now because we've had five years of good performance relative to other investments," says Michael Grupe, senior vice president of research and investment affairs at the National Association of Real Estate Investment Trusts, a trade association for REITs and publicly traded real estate companies. However, all sectors have their day in the sun, Grupe points out, and REIT stocks don't necessarily outperform all of those sectors over all of those periods. "But they are at least competitive," he says, "and that is the long-term story that needs to be told."

"REAL ESTATE IS A HYBRID INVESTMENT BETWEEN BONDS, WHICH PRODUCE MOSTLY DIVIDEND INCOME, AND STOCKS, WHICH GAIN IN VALUE MOSTLY DUE TO APPRECIATION."
– MICHAEL GRUPE

It is real estate's ability to provide another facet of balance to a long-term portfolio that earns it its designation as a fourth asset class. "Investors want diversity, reduced volatility, and reduced risk in their portfolios," Macfarlan says. "Real estate has proven to be a very valuable component in investment allocation strategies seeking to achieve those goals."

The classic argument for investing in real estate has always been that "God isn't making any more of it," but that's only true of real estate's basic raw material — Glickman's "earth." Regardless of the finite supply of earth, the overall real estate market demonstrates a significant degree of flexibility and elasticity in reacting to outside stimuli, such as supply and demand, interest rates, and macroeconomic factors. The opportunities to leverage those attributes to inject additional strength into conventional portfolio allocation is what excites investment strategists most.

Real estate differs from other types of assets in significant ways. "Within an overall portfolio context," Darst says, "real estate as an asset class may possess important defensive characteristics." Included among them are relatively low correlations of returns with traditional asset classes, such as equity and fixed income; a hedge against inflation in the general price level and generally low standard deviations of returns; and the opportunity for skilled participants to identify and capture value resulting from anomalies in this somewhat inefficient and property-specific asset class.

"It is important to note," Darst stresses, "that whenever any asset category is deemed hot in the investment realm, extra attention should be paid to risks, areas of potential overvaluation and appropriately priced hedging strategies."

A unique characteristic of real estate is the manner in which it creates value. When you look at total return figures for investment real estate over the past 20 or 30 years, dividends account for about two-thirds, appreciation for one-third. "Real estate," Grupe says, "is a hybrid investment between bonds, which produce mostly dividend income, and stocks, which gain in value mostly due to appreciation."

Perhaps the most important development in real estate's gradual immersion into the investment mainstream is a nascent, but fundamental, change in the way the real estate industry is financed. Historically, the commercial real estate sector has been the realm of the moneyed few. Entry was available only to those with access to large amounts of capital, primarily institutional investors and a handful of wealthy real estate families. Individual investors could buy a few shares of IBM, but not of Sears Tower, so the industry was financed mainly through debt.

REITs were created by an act of Congress in 1960, but for the first 30 years or so, not much happened. As late as 1993, total capitalization for REITs was less than $10 billion; today it approaches $300 billion. In recent years, top investment banks and dozens of smaller players have also created real estate "opportunity funds," and the market is even accessible to small investors through mutual funds offered by Fidelity, Merrill Lynch, Morgan Stanley, Vanguard, and other leading fund providers.

Real estate remains a predominantly private industry in the United States. Grupe estimates that it is between 85 percent and 90 percent privately run, so plenty of room exists for additional growth in the publicly traded sector. Some of the best opportunities, however, may be found in overseas markets, as a growing number of countries are developing REIT-like markets of their own.

For instance, financial upheaval in the Asian banking sector created an abundance of opportunities for real estate restructuring deals, similar to the situation in the U.S. following the Resolution Trust Corp. debacle, Macfarlan says. While much of that low-hanging fruit may already have been picked, opportunities are still available for astute investors.

However, Darst recommends that Asia be viewed on a country-by-country basis. In Hong Kong, for example, real estate prices rebounded approximately 28 percent from June 2003 through June 2004. "At the same time, it should be noted that average prices remain 55 percent below their 1997 level, when Hong Kong became a Special Administrative Region of the People's Republic of China," he adds. "Prices in Japan and Singapore have remained depressed."

Whether considering domestic or international markets, prospective real estate investors should keep their focus on the same set of criteria they apply to other types of investments, the experts emphasize. "Plant firmly in your mind that the way to look at real estate stocks is the same way you look at other publicly traded stocks," Grupe says.

The one difference may be that while people will surely continue making new stocks, no one will be making real estate — at least not in its raw form.

Michael J. McDermott has invested in real estate in Carmel, N.Y.